

Internal Revenue bulletin

Bulletin No. 1998-16
April 20, 1998

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

T.D. 8765, page 11.

Final regulations under section 985 of the Code relate to adjustments required when a qualified business unit (QBU) that used the profit and loss method of accounting (P&L) in a post-1986 year begins to use the dollar approximate separate transaction method of accounting (DASTM) and adjustments required when a QBU that used DASTM begins using P&L.

T.D. 8766, page 17.

REG-104062-97, page 20.

Final, temporary, and proposed regulations under section 1502 of the Code relate to limitations on the use of certain tax credits and related attributes by corporations filing consolidated income tax returns. A public hearing on the proposed regulations will be held on May 7, 1998.

T.D. 8767, page 4.

REG-104537-97, page 21.

Final, temporary, and proposed regulations under section 954 of the Code relate to the treatment under subpart F of certain payments involving branches of a controlled foreign

corporation (CFC) that are treated as separate entities for foreign tax purposes or partnerships in which CFCs are partners. A public hearing on the proposed regulations will be held on July 15, 1998.

EXEMPT ORGANIZATIONS

Announcement 98-29, page 48.

A list is given of organizations now classified as private foundations.

ADMINISTRATIVE

REG-208299-90, page 26.

Proposed regulations under sections 482 and 864 of the Code relate to rules for the allocation among controlled taxpayers and sourcing of income, deductions, gains and losses from a global dealing operation; rules applying these allocation and sourcing rules to foreign currency transactions and to foreign corporations engaged in a U.S. trade or business; and rules concerning the mark-to-market treatment resulting from hedging activities of a global dealing operation. A public hearing will be held on July 9, 1998.

Finding Lists begin on page 52.



Department of the Treasury
Internal Revenue Service

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our prod-

ucts and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency, and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and proce-

dures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis and are published in the first Bulletin of the succeeding semiannual period, respectively.

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For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 954.—Foreign Base Company Income

26 CFR 1.954–9T: Hybrid branches (temporary).

T.D. 8767

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 301

Guidance Under Subpart F Relating to Partnerships and Branches

AGENCY: Internal Revenue Service
(IRS), Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains regulations relating to the treatment under subpart F of certain payments involving branches of a controlled foreign corporation (CFC) that are treated as separate entities for foreign tax purposes or partnerships in which CFCs are partners. These regulations are necessary to provide guidance on transactions relating to such entities. These regulations will affect United States shareholders of controlled foreign corporations. The text of these temporary regulations also serves as the text of the proposed regulations published in REG-104537-97, page 21 of this Bulletin.

DATES: *Effective date:* These regulations are effective March 23, 1998.

Applicability date: For dates of applicability see §§1.904–5T(o), 1.954–1T(c)-(1)(i)(E), 1.954–2T(a)(5)(iii) and (a)(6)(ii), 1.954–9T(d) and 301.7701–3T(f) of these regulations.

FOR FURTHER INFORMATION CONTACT: Valerie Mark, (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

I. In general

In these temporary regulations and in proposed regulations published in REG-104537-97, the Treasury and IRS set forth a framework for dealing with is-

ssues posed by the use of certain entities that are regarded as fiscally transparent for purposes of U.S. tax law, with regard to the application of subpart F of the Internal Revenue Code.

Subpart F was enacted by Congress to limit the deferral of U.S. taxation of certain income earned outside the United States by foreign corporations controlled by U.S. persons. Limited deferral was retained after the enactment of subpart F to protect the competitiveness of controlled foreign corporations (CFCs) doing business overseas. See S. Rep. No. 1881, 87th Cong., 2d Sess. 78–80 (1962). This limited deferral furthers the objective of allowing a CFC engaged in an active business, and located in a foreign country for appropriate economic reasons, to compete in a similar tax environment with non-U.S. owned corporations located in the same country.

Conversely, one of the purposes of subpart F is to prevent CFCs from converting active income that is not easily moveable and is earned in a jurisdiction in which a business is located for non-tax reasons, into passive, easily moveable income that is shifted to a lower tax jurisdiction primarily for tax avoidance. Moreover, when subpart F was first enacted it was realized that related person transactions can be easily manipulated to reduce both United States and foreign taxes. Consequently, in enacting subpart F, Congress provided that transactions of CFCs that involve related persons generally give rise to subpart F income with certain enumerated exceptions.

Hybrid branches, which, by definition, are not regarded as fiscally transparent under foreign law, are particularly well suited to the type of tax avoidance described above. In light of the recent proliferation of hybrid branches, Treasury and the IRS believe that it is appropriate to consider the issues related to transactions involving hybrid branches, or other hybrid entities, under subpart F.

The use of partnerships that are fiscally transparent for U.S. tax purposes raises additional issues in the context of subpart F that are similar to those raised in connection with hybrid branches. Such partnerships may or may not be fiscally transparent under foreign law. (Other fis-

cally-transparent entities, such as grantor trusts, will be the subject of guidance issued in conjunction with the finalization of regulations under section 672(f).)

The entity classification regulations of §§301.7701–1 through 301.7701–3 (the check-the-box regulations) make entity classification generally elective, in part so that taxpayers can choose a tax status that is consistent with their business objectives. This administrative provision was not intended to change substantive law. Particularly in the international area, the ability to more easily achieve fiscal transparency can lead to inappropriate results under certain substantive international provisions of the Code. Thus, the Treasury and the IRS believe that it is necessary to provide additional guidance regarding the use of hybrid entities in the international context. See preamble to TD 8697, 61 Fed. Reg. 66585 (December 18, 1996).

II. Hybrid Branches

As announced in Notice 98–11 (1998–6 I.R.B. 13), the Treasury and the IRS understand that certain taxpayers are using arrangements involving hybrid branches to circumvent the purposes of subpart F (sections 951 through 964 of the Code). These arrangements generally involve the use of deductible payments to reduce the taxable income of a CFC under foreign law, thereby reducing that CFC's foreign tax and, also under foreign law, the corresponding creation in another entity of low-taxed, passive income of the type to which subpart F was intended to apply. Because of the structure of these arrangements, however, taxpayers take the position that this income is not taxed under subpart F. Treasury and the IRS have concluded that use of these hybrid branch arrangements is contrary to the policies and rules of subpart F.

U.S. international tax policy seeks to balance the objective of neutrality of taxation between domestic and foreign business enterprises (seeking neither to encourage nor to discourage one over the other), while keeping U.S. business competitive. Subpart F strongly reflects and enforces that balance, while the arrangements described above involving hybrid branches upset that balance.

Explanation of Provisions

Under these temporary regulations, hybrid branch payments, as defined in the regulations, between a CFC and its hybrid branch, or between hybrid branches of the CFC may give rise to subpart F income. When certain conditions are present, the non-subpart F income of the CFC, in the amount of the hybrid branch payment, is recharacterized as subpart F income of the CFC. Those conditions include that: the hybrid branch payment reduces the foreign tax of the payor; the hybrid branch payment would have been foreign personal holding company income if made between separate CFCs; and there is a disparity between the effective rate of tax on the payment in the hands of the payee and the hypothetical rate of tax that would have applied if the income had been taxed in the hands of the payor. Treasury and the IRS are considering applying similar principles with respect to the foreign base company services income rules of section 954(e). Comments are requested on this issue. Any regulations promulgated on this issue will be prospective.

Policies underlying subpart F would also be avoided in certain non-hybrid branch transactions that do not reduce the tax of the payor. Treasury and the IRS invite comments on the extent to which rules should be provided to address such transactions. Any regulations promulgated on this issue will be prospective. Comments are also requested regarding the application of these rules to dividend and other equity distributions.

The temporary regulations make clear that the CFC and the hybrid branch, or the hybrid branches, are treated as separate corporations only to recharacterize non-subpart F income as subpart F income in the amount of the hybrid branch payment, and to apply the tax disparity rule of §1.954-9T(a)(5)(iv). For all other purposes (e.g., for purposes of the earnings and profits limitation of section 952), a CFC and its hybrid branch, or hybrid branches, are not treated as separate corporations.

The temporary regulations provide that the amount recharacterized as subpart F income is the gross amount of the hybrid branch payment limited by the amount of the CFC's earnings and profits attributable to non-subpart F income. This

amount is the excess of current earnings and profits over subpart F income, determined after the application of the rules of sections 954(b) and 952(c) and before the application of these temporary regulations. To the extent that the full amount required to be recharacterized under this provision cannot be recharacterized because it exceeds earnings and profits attributable to non-subpart F income, there is no requirement to carry such amounts back or forward to another year.

For purposes of determining the amount of taxes deemed paid under section 960, the amount of non-subpart F income recharacterized as subpart F income is treated as attributable to income in separate foreign tax credit baskets in proportion to the ratio of non-subpart F income in each basket to the total amount of non-subpart F income of the CFC for the taxable year.

The temporary regulations provide that, under certain circumstances, the recharacterization rules will also apply to a CFC's proportionate share of any hybrid branch payment made between a partnership in which the CFC is a partner and a hybrid branch of the partnership, or between hybrid branches of such a partnership. When the partnership is treated as fiscally transparent by the CFC's taxing jurisdiction, the recharacterization rules are applied by treating the hybrid branch payment as if it had been made directly between the CFC and the hybrid branch, or as though the hybrid branches of the partnership had been hybrid branches of the CFC, as applicable. If the partnership is treated as a separate entity by the CFC's taxing jurisdiction, the recharacterization rules are applied to the partnership as if it were a CFC. Comments are requested on whether the rule for such non-fiscally transparent partnerships should be relaxed in the case of small ownership interests.

The temporary regulations provide that income will not be recharacterized unless there is a disparity between the effective rate at which the hybrid branch payment is taxed to the payee and a hypothetical tax rate that measures the tax savings to the payor from the deductible payment. This provision is similar to the rule in §1.954-3(b), and adopts the same percentage tests as contained in that provision. The regulations also provide a special high tax exception applicable to the

hybrid branch payment that is similar to the one contained in section 954(b)(4). Comments are invited on whether the rules of §1.954-9T could cause inappropriate multiple recharacterizations where the hybrid branch payments are made through a series of related hybrid entities.

The temporary regulations provide that if these provisions affect an entity that has elected under §301.7701-3(c) to be treated as an entity disregarded as separate from its owner, such an entity may elect to be classified as a corporation, provided it fulfills certain requirements, notwithstanding the sixty-month limitation in that section.

III. Related Provisions

These temporary regulations provide rules, contained in §1.954-1T(c)(1)(i)(B), to prevent expenses, including related person interest expense which would normally be allocable under section 954(b)(5) to subpart F income of a CFC, from being allocated to a payment from which the expense arises. The allocation limit applies: (i) to the extent such payment is included in the subpart F income of the CFC; (ii) if the expense arises from any payment by the CFC to a hybrid partnership in which the CFC is a partner; and (iii) if the payment reduces foreign tax and there is a significant disparity in tax rates between the payor and payee jurisdictions.

These temporary regulations also address the application of the related person exceptions to the foreign personal holding company income rules in the context of partnership distributive shares and transactions involving hybrid branches. Under section 954(c)(3), foreign personal holding company income does not include certain interest, dividends, rents and royalties received from related corporations. These exceptions apply, in the case of interest and dividends, when the related corporate payor is organized in the country in which the CFC is organized and uses a substantial part of its assets in a trade or business in that country and, in the case of rents and royalties, when the rent or royalty payment is made for the use or privilege of using property within the CFC's country of incorporation.

The rules regarding the application of the related person exceptions with respect to a CFC partner's distributive share of

partnership income are part of the broader set of rules addressing distributive share issues in the context of subpart F contained in the proposed regulations published in REG-104537-97. Certain rules relating to the related person exception with respect to a CFC partner's distributive share of partnership income, and certain rules relating to the related person exception with respect to hybrid branches, however, are included in these temporary regulations because they address a fact pattern similar to the one to which the hybrid branch payment rules apply. No inference is intended as to the treatment under existing law of such arrangements in relation to the related party exceptions.

Under these rules, if the partnership receives an item of income that reduces the income tax of the payor, the related person exceptions of section 954(c)(3) apply to exclude the income from the foreign personal holding company income of the CFC partner only where: the exception would have applied if the CFC earned the income directly (testing relatedness and country of incorporation at the CFC partner level); and either the partnership is organized and operates in the CFC's country of incorporation, the partnership is treated as fiscally transparent in the CFC's countries of incorporation and operation, or there is no significant disparity between the effective rate of tax imposed on the income and the rate of tax that would be imposed on the income if earned directly by the CFC partner.

The rules applying the related person exceptions with respect to hybrid branches address transactions illustrated in the first example of Notice 98-11 (1998-6 I.R.B. 13). These rules apply to payments by a CFC to a hybrid branch of a related CFC. Under these rules, the related person exceptions will apply to exclude the payments from the foreign personal holding company income of the recipient CFC only if the payment would have qualified for the exception if the hybrid branch had been a separate CFC incorporated in the jurisdiction in which the payment is subject to tax (other than a withholding tax).

IV. *Effective Date.*

These regulations are effective March 23, 1998. For dates of applicability see §§1.904-5T(o), 1.954-1T(c)(1)(i)(E),

1.954-2T(a)(5)(iii) and (6)(iii), 1.954-9T(d) and 301.7701-3T(f) of these regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Valerie Mark, of the Office of the Associate Chief Counsel (International). Other personnel from the IRS and Treasury Department also participated in the development of these regulations.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.904-5, paragraph (o) is amended by adding a sentence at the end to read as follows:

§1.904-5 Look-through rules as applied to controlled foreign corporations and other entities.

* * * * *

(o) * * * Paragraph (k)(1) of this section does not apply on or after March 23, 1998. For rules applicable on or after March 23, 1998, see §1.904-5T(k)(1).

Par. 3. §1.904-5T is added to read as follows:

§1.904-5T Look-through rules as applied to controlled foreign corporations and other entities (temporary).

(a) through (j) [Reserved]. For further guidance, see §1.904-5(a) through (j).

(k) *Ordering rules*—(1) *In general.* Income received or accrued by a related person to which the look-through rules apply is characterized before amounts included from, or paid or distributed by, that person and received or accrued by a related person. For purposes of determining the character of income received or accrued by a person from a related person if the payor or another related person also receives or accrues income from the recipient and the look-through rules apply to the income in all cases, the rules of paragraph (k)(2) of this section apply. Notwithstanding any other provision of this section, the principles of §1.954-1T(c)(1)(i) will apply to any expense subject to that subparagraph.

(k)(2) through (n) [Reserved]. For further guidance, see §1.904-5(k)(2) through (n).

(o) *Effective date.* Section 1.904-5T(k)(1) applies on or after March 23, 1998. For rules prior to March 23, 1998, see §1.904-5(k)(1).

Par. 4. Section 1.954-0(b) is amended by revising the paragraph heading and the entry for §1.954-0(b) in the list to read as follows:

§1.954-0 Introduction.

* * * * *

(b) *Outline of §§1.954-0, 1.954-1 and 1.954-2.*

§1.954-0 Introduction.

* * * * *

(b) *Outline of §§1.954-0, 1.954-1, and 1.954-2.*

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Par. 5. Section 1.954-1 is amended by adding a new paragraph (c)(1)(iv) to read as follows:

§1.954-1 Foreign base company income.

* * * * *

(c) * * *

(1) * * *

(iv) *Effective date.* Paragraph (c)(1)(i) of this section does not apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998. For rules applicable on or after March 23, 1998, see §1.954-1T(c)(1)(i).

Par. 6. Section 1.954-1T is added to read as follows:

§1.954-1T Foreign base company income (temporary).

(a) through (c)(1)(i) [Reserved]. For further guidance, see §1.954-1(a) through (c)(1).

(c)(1)(i) *Deductions against gross foreign base company income—(A) In general.* [Reserved]. For further guidance, see §1.954-1(c)(1)(i).

(B) *Special rule for deductible payments to certain non-fiscally transparent entities.* Notwithstanding any other provision of this section, except as provided in paragraph (c)(1)(i)(C) of this section, an expense (including a distributive share of any expense) that would otherwise be allocable under section 954(b)(5) against the subpart F income of a controlled foreign corporation shall not be allocated against subpart F income of the controlled foreign corporation resulting from the payment giving rise to the expense if—

(1) Such expense arises from a payment between the controlled foreign corporation and a partnership in which the controlled foreign corporation is a partner and the partnership is not regarded as fiscally transparent, as defined in §1.954-9T(a)(7), by any country in which the controlled foreign corporation does business or has substantial assets; and

(2) The payment from which the expense arises would have met the foreign tax reduction test of §1.954-9T(a)(3) and

the tax disparity test of §1.954-9T(a)(5)(iv) if those provisions had been applicable to the payment.

(C) *Limitations.* Paragraph (c)(1)(i)(B) shall not apply to the extent that the controlled foreign corporation partner has no income against which to allocate the expense, other than its distributive share of a payment described in paragraph (c)(1)(i)(B) of this section. Similarly, to the extent an expense described in paragraph (c)(1)(i)(B) of this section exceeds the controlled foreign corporation partner's distributive share of the payment from which the expense arises, such excess amount of the expense may reduce subpart F income (other than such payment) to which it is properly allocable or apportionable under section 954(b)(5).

(D) *Example.* The following example illustrates the application of paragraph (c)(1)(i)(B) and (C) of this section:

Example. CFC, a controlled foreign corporation in Country A, is a 70 percent partner in partnership P, located in Country B. Country A's tax laws do not classify P as a fiscally transparent entity. The rate of tax in country B is 15 percent of the tax rate in country A. P loans \$100 to CFC at a market rate of interest. In year 1, CFC pays P \$10 of interest on the loan. The interest payment would have caused the recharacterization rules of §1.954-9T to apply if the payment were made between the entities described in §1.954-9T(a)(2). CFC's distributive share of P's interest income is \$7, which is foreign personal holding company income to CFC under section 954(c). Under paragraph (c)(1)(i)(B) of this section, \$7 of the \$10 interest expense may not be allocated against any of CFC's subpart F income. However, to the extent the remaining \$3 of interest expense is properly allocable to subpart F income of CFC other than its distributive share of P's interest income, this expense may offset such other subpart F income.

(E) *Effective date.* Paragraph (c)(1)(i)(B), (C) and (D) of this section shall apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998. For rules applicable to amounts paid or

accrued pursuant to arrangements entered into before March 23, 1998, see §1.954-1.

(c)(1)(ii) through (f) [Reserved]. For further guidance, see §1.954-1(c)(1)(ii) through (f).

Par. 7. Section 1.954-2T is added to read as follows:

§1.954-2T Foreign personal holding company income (temporary).

(a)(1) through (4) [Reserved]. For further guidance, see §1.954-2(a) through (4).

(5) *Special rules applicable to distributive share of partnership income—(i) Application of related person exceptions where payment reduces foreign tax of payor.* If a partnership receives an item of income that reduced the foreign income tax of the payor (determined under the principles of §1.954-9T(a)(3)), to determine the extent to which a controlled foreign corporation's distributive share of such item of income is foreign personal holding company income, the exceptions contained in section 954(c)(3) shall apply only if—

(A)(1) Any such exception would have applied to exclude the income from foreign personal holding company income if the controlled foreign corporation had earned the income directly (determined by testing, with reference to such controlled foreign corporation, whether an entity is a related person, within the meaning of section 954(d)(3), or is organized under the laws of, or uses property in, the foreign country in which the controlled foreign corporation is created or organized); and

(2) The distributive share of such income is not in respect of a payment made by the controlled foreign corporation to the partnership; and

(B)(1) The partnership is created or organized, and uses a substantial part of its assets in a trade or business in the country under the laws of which the controlled foreign corporation is created or organized (determined under the principles of §1.954-2(b)(4));

(2) The partnership is regarded as fiscally transparent, as defined in §1.954-9T(a)(7), by all countries under the laws of which the controlled foreign corporation is created or organized or has substantial assets; or

(3) The income is taxed in the year when earned at an effective rate of tax

(determined under the principles of §1.954-1(d)(2)) that is not less than 90 percent of, and not more than five percentage points less than, the effective rate of tax that would have applied to such income under the laws of the country in which the controlled foreign corporation is created or organized if such income were earned directly by the controlled foreign corporation partner from local sources.

(ii) *Certain other exceptions applicable to foreign personal holding company income.* [Reserved].

(iii) *Effective date.* Paragraph (a)(5)(i) of this section shall apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998.

(6) *Special rules applicable to exceptions from foreign personal holding company income treatment in circumstances involving hybrid branches—(i) In general.* In the case of a payment between a controlled foreign corporation (or its hybrid branch, as defined in §1.954-9T(a)-(6)) and the hybrid branch of a related controlled foreign corporation, the exceptions contained in section 954(c)(3) shall apply only if the payment would have qualified for the exception if the payor were a separate controlled foreign corporation created or organized in the jurisdiction where foreign tax is reduced and the payee were a separate controlled foreign corporation created or organized under the laws of the jurisdiction in which the payment is subject to tax (other than a withholding tax).

(ii) *Exception where no tax reduction or tax disparity.* Paragraph (a)(6)(i) of this section shall not apply unless the payment would have met the foreign tax reduction test of §1.954-9T(a)(3) and the tax disparity test of §1.954-9T(a)(5)(iv) if those provisions had been applicable to the payment.

(iii) *Effective date.* The rules of this section shall apply to all amounts paid or accrued on or after January 16, 1998, except for amounts paid or accrued pursuant to arrangements entered into before January 16, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after January 16, 1998.

(b) through (h) [Reserved]. For further guidance, see §1.954-2(b) through (h).

Par. 8. Section 1.954-9T is added to read as follows:

§1.954-9T Hybrid branches (temporary).

(a) *Subpart F income arising from certain payments involving hybrid branches—(1) Payment causing foreign tax reduction gives rise to additional subpart F income.* The non-subpart F income of the controlled foreign corporation will be recharacterized as subpart F income, to the extent provided in paragraph (a)(5) of this section, if—

(i) A hybrid branch payment, as defined in paragraph (a)(6) of this section, is made between the entities described in paragraph (a)(2) of this section;

(ii) The hybrid branch payment reduces foreign tax, as determined under paragraph (a)(3) of this section; and

(iii) The hybrid branch payment is treated as falling within a category of foreign personal holding company income under the rules of paragraph (a)(4) of this section.

(2) *Hybrid branch payment between certain entities—(i) In general.* Paragraph (a)(1) of this section shall apply to hybrid branch payments between—

(A) A controlled foreign corporation and its hybrid branch;

(B) Hybrid branches of a controlled foreign corporation;

(C) A partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships) and a hybrid branch of the partnership; or

(D) Hybrid branches of a partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships).

(ii) *Hybrid branch payment involving partnership—(A) Fiscally transparent partnership.* To the extent of the controlled foreign corporation's proportionate share of a hybrid branch payment, the rules of paragraphs (a)(3), (4) and (5) of this section shall be applied by treating the hybrid branch payment between the partnership and the hybrid branch as if it were made directly between the controlled foreign corporation and the hybrid branch, or as if the hybrid branches of the partnership were hybrid branches of the controlled foreign corporation, if the hybrid branch payment is made between—

(1) A fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other fiscally transparent partnerships) and the partnership's hybrid branch; or

(2) Hybrid branches of a fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other fiscally transparent partnerships).

(B) *Non-fiscally transparent partnership.* To the extent of the controlled foreign corporation's proportionate share of a hybrid branch payment, the rules of paragraphs (a)(3) and (4) and (a)(5)(iv) of this section shall be applied to the non-fiscally transparent partnership as if it were the controlled foreign corporation, if the hybrid branch payment is made between—

(1) A non-fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships) and the partnership's hybrid branch; or

(2) Hybrid branches of a non-fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships).

(C) *Examples.* The following examples illustrate the application of this paragraph (a)(2)(ii).

Example 1. CFC, a controlled foreign corporation in Country A, is a 90 percent partner in partnership P, which is treated as fiscally transparent under the laws of Country A. P has a hybrid branch, BR,

in Country B. P makes an interest payment of \$100 to BR. Under Country A law, CFC's 90 percent share of the payment reduces CFC's Country A income tax. Under paragraph (a)(2)(ii)(A) of this section, the recharacterization rules of this section are applied by treating the payment as if made by CFC to BR. Ninety dollars of CFC's non-subpart F income, to the extent available, and subject to the earnings and profits and tax rate limitations of §1.954-9T(a)(5), is recharacterized as subpart F income.

Example 2. CFC, a controlled foreign corporation in Country A, is a 90 percent partner in partnership P, which is treated as fiscally transparent under the laws of Country A. P has two branches in Country B, BR1 and BR2. BR1 is treated as fiscally transparent under the laws of Country A. BR2 is a hybrid branch. BR1 makes an interest payment of \$100 to BR2. Under paragraph (a)(2)(ii)(A) of this section, the payment by BR1, the fiscally transparent branch, is treated as a payment by P, and the deemed payment by P, a fiscally transparent partnership, is treated as made by CFC. Under Country A law, CFC's 90 percent share of BR1's payment reduces CFC's Country A income tax. Ninety dollars of CFC's non-subpart F income, to the extent available, and subject to the earnings and profits and tax rate limitations of §1.954-9T(a)(5), is recharacterized as subpart F income.

(3) *Application when payment reduces foreign tax.* For purposes of paragraph (a)(1) of this section, a hybrid branch payment reduces foreign tax when the foreign tax imposed on the income of the payor or any owner of the payor is less than the foreign tax that would have been imposed on such income had the hybrid branch payment not been made, or the hybrid branch payment creates or increases a loss or deficit or other tax attribute which may be carried back or forward to reduce the foreign income tax of the payor or any owner in another year (determined by taking into account any refund of such tax made to the payor, payee or any other person).

(4) *Hybrid branch payment that is included within a category of foreign personal holding company income—(i) In general.* For purposes of paragraph (a)(1) of this section, whether the hybrid branch payment is treated as income included within a category of foreign personal holding company income is determined by treating a hybrid branch that is either the payor or recipient of the hybrid branch payment as a separate wholly-owned subsidiary corporation of the controlled foreign corporation that is incorporated in the jurisdiction under the laws of which such hybrid branch is created, organized for foreign law purposes, or has substantial assets. Thus, the hybrid branch pay-

ment will be treated as included within a category of foreign personal holding company income if, taking into account any specific exceptions for that category, the payment would be included within a category of foreign personal holding company income if the branch or branches were treated as separately incorporated for U.S. tax purposes.

(ii) *Extent to which controlled foreign corporation and hybrid branches treated as separate entities.* For purposes other than the determination under paragraph (a)(4)(i) of this section, a controlled foreign corporation and its hybrid branch, a partnership and its hybrid branch, or hybrid branches shall not be treated as separate entities. Thus, for example, if a controlled foreign corporation, including all of its hybrid branches, has an overall deficit in earnings and profits to which section 952(c) applies, the limitation of such section on the amount includible in the subpart F income of such corporation will apply. Similarly, for purposes of applying the de minimis and full inclusion rules of section 954(b)(3), a controlled foreign corporation and its hybrid branch, or hybrid branches shall not be treated as separate corporations. Further, a hybrid branch payment that would reduce foreign personal holding company income under section 954(b)(5) if made between two separate entities will not create an expense if made between a controlled foreign corporation and its hybrid branch, a partnership and its hybrid branch, or hybrid branches.

(5) *Recharacterization of income attributable to current earnings and profits as subpart F income—(i) General rule.* Non-subpart F income of a controlled foreign corporation in an amount equal to the excess of earnings and profits of the controlled foreign corporation for the taxable year over subpart F income, as defined in section 952(a), will be recharacterized as subpart F income under paragraph (a)(1) of this section only to the extent provided under paragraphs (a)(5)(ii) through (vi) of this section.

(ii) *Subpart F income.* For purposes of determining the excess of current earnings and profits over subpart F income under paragraph (a)(1) of this section, the amount of subpart F income is determined before the application of the rules of this section but after the application of the

rules of sections 952(c) and 954(b). Further, such amount is determined by treating the controlled foreign corporation and all of its hybrid branches as a single corporation.

(iii) *Recharacterization limited to gross amount of hybrid branch payment—(A) In general.* The amount recharacterized as subpart F income under paragraph (a)(1) of this section is limited to the amount of the hybrid branch payment.

(B) *Exception for duplicative payments.* [Reserved].

(iv) *Tax disparity rule—(A) In general.* Paragraph (a)(1) of this section will apply only if the hybrid branch payment falls within the tax disparity rule. The hybrid branch payment falls within the tax disparity rule if it is taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the hypothetical effective rate of tax imposed on the hybrid branch payment, as determined under paragraph (a)(5)(iv)(B) of this section.

(B) *Hypothetical effective rate of tax—(1) In general.* The hypothetical effective rate of tax imposed on the hybrid branch payment is—

(i) For the taxable year of the payor in which the hybrid branch payment is made, the amount of income taxes that would have been paid or accrued by the payor if the hybrid branch payment had not been made, less the amount of income taxes paid or accrued by the payor; divided by

(ii) The amount of the hybrid branch payment.

(2) *Hypothetical effective rate of tax when hybrid branch payment causes or increases loss or deficit.* If the hybrid branch payment causes or increases a loss or deficit of the payor for foreign tax purposes, and such loss or deficit can be carried forward or back, the hypothetical effective rate of tax imposed on the hybrid branch payment is the effective rate of tax that would be imposed on the taxable income of the payor for the year in which the foreign law payment is made if the payor's taxable income were equal to the amount of the hybrid branch payment.

(C) *Examples.* The application of this paragraph (a)(5)(iv) is illustrated by the following examples.

Example 1. In 1998, CFC organized in Country A had net income of \$60 from manufacturing for

Country A tax purposes. It also had a branch (BR) in Country B. BR is a hybrid entity under paragraph (a)(1) of this section. CFC made a payment of \$40 to BR, which was a hybrid branch payment under paragraph (a)(6) of this section, and was treated by CFC as a deductible payment for Country A tax purposes. CFC paid \$30 of Country A taxes in 1998. It would have paid \$50 of Country A taxes without the deductible payment. Country A did not impose any withholding tax on the \$40 payment to BR. Country B also did not impose a tax on the \$40 received by BR. Therefore, the effective rate of tax on that payment is 0%. Furthermore, the hypothetical effective rate of tax on the \$40 hybrid branch payment is 50% (\$50-\$30/\$40). The effective rate of tax (0%) is less than 90% of, and more than 5 percentage points less than, this hypothetical rate of tax of 50%. As a result, the \$40 hybrid branch payment falls within the tax disparity rule of this paragraph (a)(5)(iv).

Example 2. Assume the same facts as in *Example 1*, except that CFC has a loss of \$100 for the year for Country A tax purposes. Under Country A law, CFC can carry the loss forward for use in subsequent years. CFC paid no Country A taxes in 1998. The rate of tax in Country A is graduated from 20% to 50%. If the \$40 hybrid branch payment were the only item of taxable income of CFC, Country A would have imposed tax at an effective rate of 30%. The effective rate of tax (0%) is less than 90 percent of, and more than 5 percentage points less than, the hypothetical effective rate of tax (30%) imposed on the hybrid branch payment. As a result, the \$40 hybrid branch payment falls within the tax disparity rule of this paragraph (a)(5)(iv).

Example 3. Assume the same facts as in *Example 1*, except that Country B imposes tax on the \$40 hybrid payment to BR at an effective rate of 50%. The effective rate of 50% is equal to the hypothetical effective rate of tax. As a result, the hybrid branch payment does not fall within the tax disparity rule of this paragraph (a)(5)(iv) and, thus, the recharacterization rules of paragraph (a)(1) of this section do not apply. See also the special high tax exception of paragraph (a)(5)(v) of this section.

(v) *Special high tax exception—(A) In general.* Paragraph (a)(1) of this section shall not apply if the non-subpart F income recharacterized as subpart F income under this section was subject to foreign income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 for the taxable year of the controlled foreign corporation.

(B) *Effective rate of tax.* The effective rate of tax imposed on the net amount of the hybrid branch payment is determined under the principles of §1.954-1(d)(2) and (3). See paragraph (c) of this section for the application of section 960 to amounts recharacterized as subpart F income under this section.

(vi) *No carryback or carryforward of amounts in excess of current year earn-*

ings and profits limitation. To the extent that some or all of the amount required to be recharacterized under this section is not recharacterized as subpart F income because the hybrid branch payment exceeds the amount that can be recharacterized, as determined under paragraph (a)(5)(i) of this section, this excess shall not be carried back or forward to another year.

(6) *Definitions.* For purposes of this section—

Entity means any person that is treated by the United States or any jurisdiction as other than an individual.

Hybrid branch means an entity that—

(i) Has a single owner (including ownership through branches) that is either a controlled foreign corporation or a partnership in which a controlled foreign corporation is a partner (either directly or indirectly through one or more branches or partnerships);

(ii) Is treated as fiscally transparent by the United States; and

(iii) Is treated as non-fiscally transparent by the country in which the payor entity, any owner of a fiscally-transparent payor entity, the controlled foreign corporation, or any intermediary partnership is created, organized or has substantial assets.

Hybrid branch payment means the gross amount of any payment (including any accrual) which, under the tax laws of any foreign jurisdiction to which the payor is subject, is regarded as a payment between two separate entities but which, under U.S. income tax principles, is not income to the recipient because it is between two parts of a single entity.

(7) *Fiscally transparent and non-fiscally transparent.* For purposes of this section an entity shall be treated as fiscally transparent with respect to an interest holder of the entity, if such interest holder is required, under the laws of any jurisdiction to which it is subject, to take into account separately, on a current basis, such interest holder's share of all items which, if separately taken into account by such interest holder, would result in an income tax liability for the interest holder in such jurisdiction different from that which would result if the interest holder did not take the share of such items into account separately. A non-fiscally transparent entity is an entity that is not fis-

cally transparent under this paragraph (a)(7).

(b) *Election to change classification—(1) In general.* If a hybrid branch subject to the provisions of paragraph (a) of this section is an entity that has made an election under §301.7701-3(c)(1) of this chapter to be disregarded as an entity separate from its owner, such entity may elect to change its classification to that of an association taxable as a corporation, under the procedures described in §301.7701-3(c) of this chapter, without regard to the limitation of §301.7701-3T(c)(1)(iv) of this chapter, but only if such election is made on or before the last day of the first taxable year beginning on or after January 1, 1998. An election made pursuant to this paragraph (b)(1) is effective as of the first day of such taxable year. The 75 day limitation on retroactivity in §301.7701-3(c)(1)(iii) of this chapter does not apply.

(2) *Limitation.* An entity can elect to change its classification under the provisions of this paragraph only one time.

(c) *Application of section 960.* For purposes of determining the amount of taxes deemed paid under section 960, the amount of non-subpart F income recharacterized as subpart F income under this section shall be treated as attributable to income in separate categories, as defined in §1.904-5(a)(1), in proportion to the ratio of non-subpart F income in each such category to the total amount of non-subpart F income of the controlled foreign corporation for the taxable year.

(d) *Effective dates—(1) Hybrid branches of controlled foreign corporations.* With respect to hybrid branch payments described in paragraph (a)(2)(i)(A) and (B) of this section, the rules of this section shall apply to all amounts paid or accrued on or after January 16, 1998, except for amounts paid or accrued pursuant to arrangements entered into before January 16, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after January 16, 1998.

(2) *Hybrid branches of partnerships in which controlled foreign corporations are partners.* With respect to hybrid branch payments described in paragraph (a)(2)-(i)(C) and (D) of this section, the rules of this section shall apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 9. The authority citation for 26 CFR part 301 continue to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 10. In §301.7701-3, paragraph (f)(1) is amended by adding a sentence at the end to read as follows:

§301.7701-3. Classification of certain business entities.

* * * * *

(f)(1) * * * Paragraphs (a), (c)(1)(iv) and (f) of this section do not apply on or after March 23, 1998. For rules applicable on or after March 23, 1998, see §301.7701-3T(a), (c)(1)(iv) and (f).

Par. 11. Section 301.7701-3T is added to read as follows:

§301.7701-3T Classification of certain business entities (temporary).

(a) *In general.* A business entity that is not classified as corporation under §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under §301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disre-

garded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. Paragraph (c) of this section provides rules for making express elections. Paragraph (d) provides special rules for foreign eligible entities. Paragraph (e) of this section provides special rules for classifying entities resulting from partnership terminations and divisions under section 708(b). Paragraph (f) of this section sets forth the effective date of this section and a special rule relating to prior periods. An entity that has elected to be disregarded as an entity separate from its owner may nevertheless be treated as a corporation for the limited purposes of §1.954-9T(a)(4)(i) of this chapter.

(b) through (c)(1)(iii) [Reserved]. For further guidance, see §301.7701-3(b) through (c)(1)(iii).

(c)(1)(iv) *Limitation.* If an eligible entity makes an election under paragraph (c)(1)(i) of this section to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the sixty months succeeding the effective date of the election. However, the Commissioner may permit the entity to change its classification by election within the sixty months if more than fifty percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by person that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election. See §1.954-9T(b) of this chapter, for circumstances under which certain eligible entities may make an election to change their classification within the sixty-month period.

(c)(1)(v) through (e) [Reserved]. For further guidance, see §301.7701-3(c)(1)(v) through (e).

(f) *Effective date.* Section 301.7701-3T(a) and (c)(1)(iv) applies on or after March 23, 1998. For rules prior to March 23, 1998, see §301.7701-3(a) and (c)(1)(iv).

Michael P. Dolan,
Deputy Commissioner of
Internal Revenue.

Donald C. Lubick,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on March 23, 1998, 12:58 p.m., and published in the issue of the Federal Register for March 26, 1998, 63 F.R. 14613)

Section 985.—Functional Currency

26 CFR 1.985-1: Functional currency.

T.D. 8765

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Change From Dollar
Approximate Separate
Transactions Method of
Accounting (DASTM) to the
Profit and Loss Method of
Accounting/Change From the
Profit and Loss Method to
DASTM

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final Income Tax Regulations relating to adjustments required when a qualified business unit (QBU) that used the profit and loss method of accounting (P&L) in a post-1986 year begins to use the dollar approximate separate transaction method of accounting (DASTM) and adjustments required when a QBU that used DASTM begins using P&L. The regulations provide rules for taxpayers to construct an

opening dollar balance sheet for the QBU and require income adjustments in certain cases.

DATES: These regulations are effective April 6, 1998.

FOR FURTHER INFORMATION CONTACT: Howard Wiener at (202) 622-3870 (not a toll-free number) of the office of Chief Counsel (International) within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

Background

On January 5, 1993 and July 25, 1994, the IRS published proposed amendments to §1.985-7 in the **Federal Register** at 58 F.R. 300 (INTL-0045-92) and §1.985-1 in the **Federal Register** at 59 F.R. 37733 (INTL-0066-92), respectively. No public hearing was held and few comments were received. After consideration of these comments, the regulations are adopted as a Treasury Decision with modifications as described below.

Explanation of Provisions

I. Proposed Rules for Changing From P&L to DASTM (§1.985-7)

1. The Proposed Regulations

The proposed regulations under §1.985-7 set forth transition rules for QBUs changing from the profit and loss method of accounting (P&L) to DASTM in tax years after 1987. Section 1.985-6 provides the translation rules for QBUs using DASTM in 1987. Generally, when a QBU changes its functional currency, two basic issues arise: (1) How should the QBU translate its balance sheet accounts into the new functional currency in a way that preserves any unrecognized currency gain or loss which accrued in the old functional currency; and (2) whether income adjustments need to be made to recognize any currency gain or loss which accrued in the old functional currency that cannot be preserved.

Section 1.985-5 provides rules that generally apply when a QBU changes its functional currency. Under §1.985-5 balance sheet accounts are translated using the spot rate on the last day prior to the

taxable year of change. In addition, §1.985-5 generally requires recognition of unrealized exchange gain or loss on instruments and other accounts that were maintained in the functional currency to which the QBU is changing.

The proposed regulations issued under §1.985-7 were issued in response to taxpayer comments that §1.985-5 resulted in significant distortions when a QBU either elected or was required to use DASTM. Applying the spot rate on the last day prior to the year in which the QBU begins to use DASTM (the “taxable year of change”) to translate fixed assets typically results in a significant loss of basis in dollar terms and does not take into account certain income and expense distortions that occur in the period immediately preceding the taxable year of change.

In response to taxpayers’ comments, the proposed regulations provide for use of the translation rules provided under §1.985-3. These rules generally translate fixed assets at the historical exchange rate and other assets and liabilities at the current exchange rate. To correct for distortions that would result from applying historic exchange rates for fixed assets while applying the current year’s spot rate for other balance sheet accounts, the proposed regulations provide for income adjustments in the case of a controlled foreign corporation (CFC) and a branch that reflect amounts that would have been included in income under DASTM.

In the case of a CFC, the proposed regulations provide for a shareholder level income adjustment to the extent subpart F income realized during the period after 1986 until the taxable year of change differs from subpart F income that would have been realized if the CFC had used DASTM throughout this period. In the case of a branch, the regulations provide that any difference between the branch’s local currency equity translated into dollars at the spot exchange rate on the last day prior to the taxable year of change and the taxpayer’s dollar basis pool on that day is included in income over three taxable years beginning with the taxable year of change. For purposes of translating the balance sheet of noncontrolled section 902 corporations, the proposed regulations apply historic exchange rates for fixed assets. In such case, no shareholder level income adjustments are required.

Recognizing the administrative burden of making income adjustments for all post-1986 tax years in the case of a CFC, the preamble to the proposed regulations requested comments regarding three alternative transition rules as follows: (1) requiring shareholder level adjustments for the three-year base period used to determine the hyperinflationary status of the local currency, (in which case the general rule of §1.985-5 would be applied in preparing the balance sheet for the first year of the base period); (2) treating a portion of retained earnings as subpart F income based on an average historical rate of subpart F income to total earnings and profits, and (3) using the spot rate on the last day prior to the taxable year of change to translate balance sheet items with special rules to allow historical exchange rates to translate fixed assets to the extent of unrealized exchange loss on paid-in capital.

2. Reasons for change

The IRS is concerned that the approach of the proposed regulations could create a significant administrative burden for shareholders of CFCs. The administrative burden results from the requirement that shareholders recompute subpart F income for all of the CFC’s post 1986 taxable years. If the functional currency of a CFC becomes hyperinflationary in a year that is significantly distant from the CFC’s first post-1986 taxable year, records supporting the required recomputation may be unavailable.

Further, the required recomputation under the proposed regulations is generally inconsistent with the policy of sections 986 and 987 that the income of branches with a functional currency different than that of the taxpayer and the earnings and profits of foreign corporations be computed under a profit and loss method, except in the case of hyperinflation. See S. Rep. No. 99-313, 99th Cong., 2d Sess., 454 (1986). The recomputation under the proposed regulation would put the CFC on DASTM for non-hyperinflationary years. Accordingly, the rules in the proposed regulations have been modified as described below.

II. Final Regulations for Changing From P&L to DASTM (§1.985-7)

1. General Rule

The approach employed in the final

regulations has the general effect of treating a QBU as if it had applied §1.985-5 on the last day of the last taxable year prior to the base period for determining whether a currency is hyperinflationary (transition date) and had applied DASTM during the taxable years beginning after the transition date until the taxable year of change (look-back period). This approach addresses the problems of applying §1.985-5 in the taxable year of change for purposes of translating fixed assets by applying the historical exchange rate to the extent fixed assets were acquired during the look-back period. Assets acquired prior to the look-back period are translated by applying the spot rate on the transition date. This approach also corrects distortions in income and expense (generally interest income and expense) that occur during the look-back period.

The final regulations respond to taxpayers' comments and provide an appropriate rule for translating the adjusted basis of fixed assets into dollars by applying an exchange rate in effect prior to the hyperinflationary period. Moreover, this method more accurately reflects Congressional intent for QBUs to apply the profit and loss method except in the case of hyperinflation. In addition, this approach decreases the administrative burden of changing to DASTM.

2. Foreign Corporations

In the case of a foreign corporation which is either required or elects to use DASTM, four basic corporate level adjustments are required as follows. (1) The balance sheet is translated by treating the corporation as if it had changed its functional currency to the dollar for the first post-transition date taxable year and had applied the rules of §1.985-5(c) on the transition date. Assets acquired and liabilities incurred in the functional currency during the look-back period are translated by applying the rules of §1.985-3. (2) The unrealized gain or loss on dollar denominated section 988 transactions as determined on the transition date are treated as if recognized on that date (and actual gain or loss recognized on dollar denominated section 988 transactions during the look-back period is reversed). (3) The dollar value of the pre-1987 E&P of the corporation as stated on the transition date in the functional currency is translated

into U.S. dollars at the spot rate in effect on the transition date. (4) The dollar value of the post-1986 E&P is computed by translating the post-1986 E&P as stated on the transition date in the functional currency at the spot rate on such date and adding to it the E&P for the years during the look-back period as computed under DASTM.

In the case of a CFC, there are three shareholder level adjustments as follows: (1) The U.S. shareholders must take into income exchange gain or loss on the deemed recognition of the section 988 transactions as determined at the corporate level to the extent such gain or loss is subpart F income. (2) The U.S. shareholders must recognize foreign currency gain or loss as computed under section 986(c) as if all previously taxed earnings and profits were distributed on the transition date (however, any actual 986(c) gain or loss recognized during the look-back period is reversed). (3) The subpart F income of the CFC is recomputed during the look-back period under DASTM and compared to the subpart F income as computed under the P&L method. The difference (positive or negative) is taken into account in the taxable year of change and spread over four years. Similar rules apply to United States persons who have made an election under section 1295 to treat a passive foreign investment company as a qualified electing fund. In the case of other foreign corporations, no shareholder level income adjustments are necessary.

4. Branches

In accord with the general approach articulated above, the regulations treat a branch changing to DASTM as applying the principles of §1.985-5 on the transition date. Thus, the balance sheet is translated by treating the branch as if it had changed its functional currency to the dollar for the first post-transition date taxable year and had applied the rules of §1.985-5(c) on the transition date. Unrealized gain or loss on dollar denominated section 988 transactions as stated on the transition date are treated as if recognized on that date (and any actual gain or loss realized with respect to section 988 transactions during the look-back period is reversed). Further, the regulations require that the taxpayer recognize gain or loss attributable to the branch's equity pool (as stated

on the transition date) under the principles of section 987, computed as if the branch terminated on the transition date. Such gain or loss is reduced by any section 987 gain and increased by any section 987 loss that was recognized by the taxpayer with respect to remittances during the look-back period. Finally, branch income shall be determined under §1.985-3 for each look-back year and compared to the amount that was taken into account for each year. The sum of the difference (positive or negative) is taken into account in the taxable year of change and spread over four years.

III. Rules for Changing from DASTM to P&L (§1.985-1)

Under the proposed regulation, a QBU that has been required or had elected to use DASTM must change functional currency to the currency of its economic environment in a year in which the currency is no longer hyperinflationary pursuant to the three-year test under §1.985-1(b). These rules provide that when a taxpayer changes from DASTM to the P&L method of accounting, §1.985-5 shall apply for purposes of translating a QBU's balance sheet and for making certain income adjustments. Because these rules generally do not create distortions and are administrable, the final regulations adopt these regulations as proposed.

IV. Other Changes

Various conforming changes have been made to §§1.985-1 and 1.985-5 to account for the addition of §1.985-7. In addition, the definition of hyperinflation has been liberalized to provide that for purposes of determining whether a currency is hyperinflationary for income tax purposes, United States generally accepted accounting principles will be accepted provided that the determination is based on criteria that is substantially similar to the general rules provided in the regulations, the method of determination is applied consistently from year to year, and the same method is applied to all related persons.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866.

Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Howard A. Wiener of the Office of the Associate Chief Counsel (International). Other personnel from the IRS and Treasury Department also participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.985-1 is amended by:
1. Revising paragraph (b)(2)(ii)(C).
2. Adding a sentence to the end of paragraph (b)(2)(ii)(D).

3. Adding paragraph (b)(2)(ii)(E).
The additions and revision reads as follows:

§1.985-1. Functional currency.

* * * * *

- (b) * * *
- (2) * * *
- (ii) * * *

(C) *Change in functional currency.* If a QBU is required to change its functional currency to the dollar under paragraph (b)(2)(ii)(A) of this section, or chooses or is required to change its functional currency to the dollar for any open taxable year (and all subsequent taxable years) under §1.985-3(a)(2)(ii), the change is

considered to be made with the consent of the Commissioner for purposes of §1.985-4. A QBU changing functional currency must make adjustments described in §1.985-7 if the year of change (as defined in §1.481-1(a)(1)) begins after 1987, or the adjustments described in §1.985-6 if the year of change begins in 1987. No adjustments under section 481 are required solely because of a change in functional currency described in this paragraph (b)(2)(ii)(C).

(D) * * * In making the determination whether a currency is hyperinflationary, the determination for purposes of United States generally accepted accounting principles may be used for income tax purposes provided the determination is based on criteria that is substantially similar to the rules previously set forth in this paragraph (b)(2)(ii)(D), the method of determination is applied consistently from year to year, and the same method is applied to all related persons as defined in §1.985-3(e)(2)(vi).

(E) *Change in functional currency when currency ceases to be hyperinflationary—(1) In general.* A QBU that has been required to use the dollar as its functional currency under paragraph (b)(2) of this section, or has elected to use the dollar as its functional currency under paragraph (b)(2)(ii)(B)(2) of this section or §1.985-2, must change its functional currency as of the first day of the first taxable year that follows three consecutive taxable years in which the currency of its economic environment, determined under paragraph (c)(2) of this section, is not a hyperinflationary currency. The functional currency of the QBU for such year shall be determined in accordance with paragraph (c) of this section. For purposes of §1.985-4, the change is considered to be made with the consent of the Commissioner. See §1.985-5 for adjustments that are required upon a change in functional currency.

(2) *Effective Date.* This paragraph (b)(2)(ii)(E) of this section applies to taxable years beginning after April 6, 1998.

Par. 3. Section 1.985-5(a) is amended by adding the following sentence to the end of the paragraph:

§1.985-5 Adjustments required upon change in functional currency.

(a) * * *

However, a QBU that changes to the dollar pursuant to §1.985-1(b)(2) after 1987 shall apply §1.985-7.

* * * * *

Par. 4. Section 1.985-7 is added as follows:

1.985-7 Adjustments required in connection with a change to DASTM.

(a) *In general.* If a QBU begins to use the dollar approximate separate transactions method of accounting set forth in §1.985-3 (DASTM) in a taxable year beginning after April 6, 1998, adjustments shall be made as provided by this section. For the rules with respect to foreign corporations, see paragraph (b) of this section. For the rules with respect to adjustments to the income of United States shareholders of controlled foreign corporations, see paragraph (c) of this section. For the rules with respect to adjustments relating to QBU branches, see paragraph (d) of this section. For the effective date of this section, see paragraph (e). For purposes of applying this section, the look-back period shall be the period beginning with the first taxable year after the transition date and ending on the last day prior to the taxable year of change. The term transition date means the later of the last day of the last taxable year ending before the base period as defined in §1.985-1(b)(2)(ii)(D) or the last day of the taxable year in which the QBU last applied DASTM. The taxable year of change shall mean the taxable year of change as defined in §1.481-1(a)(1). The application of this paragraph may be illustrated by the following examples:

Example 1. A calendar year QBU that has not previously used DASTM operates in a country in which the functional currency of the country is hyperinflationary as defined under §1.985-1(b)(2)(ii)(D) for the QBU's 1999 tax year. The look-back period is the period from January 1, 1996 through December 31, 1998, the transition date is December 31, 1995, and the taxable year of change is the taxable year beginning January 1, 1999.

Example 2. A QBU that has not previously used DASTM with a taxable year ending June 30, operates in a country in which the functional currency of the country is hyperinflationary for the QBU's tax year beginning July 1, 1999 as defined under §1.985-1(b)(2)(ii)(D) (where the base period is the thirty-six calendar months immediately preceding the first day of the current calendar year 1999). The look-back period is the period from July 1, 1995 through June 30, 1999, the transition date is June 30, 1995, and the taxable year of change is the taxable year beginning July 1, 1999.

(b) *Adjustments to foreign corporations*—(1) *In general.* In the case of a foreign corporation, the corporation shall make the adjustments set forth in paragraphs (b)(2) through (4) of this section. The adjustments shall be made on the first day of the taxable year of change.

(2) *Treatment of certain section 988 transactions*—(i) *Exchange gain or loss from section 988 transactions unrealized as of the transition date.* A foreign corporation shall adjust earnings and profits by the amount of any unrealized exchange gain or loss that was attributable to a section 988 transaction (as defined in sections 988(c)(1)(A), (B), and (C)) that was denominated in terms of (or determined by reference to) the dollar and was held by the corporation on the transition date. Such gain or loss shall be computed as if recognized on the transition date and shall be reduced by any gain and increased by any loss recognized by the corporation with respect to such transaction during the look-back period. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (i.e., whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988. Proper adjustments shall be made to account for gain or loss taken into account by reason of this paragraph (b)(2). See §1.985-5(f) *Example 1, footnote 1.*

(ii) *Treatment of a section 988 transaction entered into and terminated during the look-back period.* A foreign corporation shall reduce earnings and profits by the amount of any gain, and increase earnings and profits by the amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

(3) *Opening balance sheet.* The opening balance sheet of a foreign corporation for the taxable year of change shall be determined as if the corporation had changed its functional currency to the dollar by applying § 1.985-5(c) on the transition date and had translated its assets and liabilities under §1.985-3 during the look-back period.

(4) *Earnings and profits adjustments*—(i) *Pre-1987 accumulated profits.* The foreign income taxes and accumulated profits or deficits in accumulated

profits of a foreign corporation that are attributable to taxable years beginning before January 1, 1987, as stated on the transition date, and that were maintained for purposes of section 902 in the old functional currency, shall be translated into dollars at the spot rate in effect on the transition date. The applicable accumulated profits shall be reduced on a last-in, first-out basis by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) attributable to earnings and profits that were distributed (or treated as distributed) during the look-back period to the extent such amounts distributed exceed the earnings and profits calculated under (b)(4)(ii) or (b)(4)(iii), as applicable. See §1.902-1(b)(2)(ii). Once translated into dollars, these pre-1987 taxes and accumulated profits or deficits in accumulated profits shall (absent a change in functional currency) remain in dollars for all federal income tax purposes.

(ii) *Post-1986 undistributed earnings of a CFC.* In the case of a controlled foreign corporation (within the meaning of section 957 or section 953(c)(1)(B))—(CFC) or a foreign corporation subject to the rules of §1.904-6(a)(2), the corporation's post-1986 undistributed earnings in each separate category as defined in §1.904-5(a)(1) as of the first day of the taxable year of change (and prior to adjustment under paragraph (c)(1) of this section) shall equal the sum of—

(A) The corporation's post-1986 undistributed earnings and profits (or deficit in earnings and profits) in each separate category as defined in §1.904-5(a)(1) as stated on the transition date translated into dollars at the spot rate in effect on the transition date; and

(B) The sum of the earnings and profits (or deficit in earnings and profits) in each separate category determined under §1.985-3 for each post-transition date taxable year prior to the taxable year of change.

Such amount shall be reduced by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) attributable to earnings and profits that were distributed (or treated as distributed) during the look-back period out of post-1986 earnings and profits in such separate category. For purposes of applying this paragraph

(b)(4)(ii)(B), the opening balance sheet for calculating earnings and profits under §1.985-3 for the first post-transition year shall be translated into dollars pursuant to §1.985-5(c).

(iii) *Post-1986 undistributed earnings of other foreign corporations.* In the case of a foreign corporation that is not a CFC or subject to the rules of §1.904-6(a)(2), the corporation's post-1986 undistributed earnings shall equal the sum of—

(A) The corporation's post-1986 undistributed earnings (or deficit) on the transition date translated into dollars at the spot rate in effect on the transition date; and

(B) The sum of the earnings and profits (or deficit in earnings and profits) determined under §1.985-3 for each post-transition date taxable year (or such later year determined under section 902(c)-(3)(A)) prior to the taxable year of change.

Such amount shall be reduced by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) that was distributed (or treated as distributed) during the look-back period out of post-1986 earnings and profits. For purposes of applying this paragraph (b)(4)(iii)(B), the opening balance sheet for calculating earnings and profits under §1.985-3 for the first post-transition year shall be translated into dollars pursuant to §1.985-5(c).

(c) *United States shareholders of controlled foreign corporations*—(1) *In general.* A United States shareholder (within the meaning of section 951(b) or section 953(c)(1)(B)) of a CFC that changes to DASTM shall make the adjustments set forth in paragraphs (c)(2) through (5) of this section on the first day of the taxable year of change. Adjustments under this section shall be taken into account by the shareholder (or such shareholder's successor in interest) ratably over four taxable years beginning with the taxable year of change. Similar rules shall apply in determining adjustments to income of United States persons who have made an election under section 1295 to treat a passive foreign investment company as a qualified electing fund.

(2) *Treatment under subpart F of income recognized on section 988 transactions.* The character of amounts taken into account under paragraph (b)(2) of

this section for purposes of sections 951 through 964, shall be determined on the transition date and to the extent characterized as subpart F income shall be taken into account in accordance with the rules of paragraph (c)(1) of this section. Such amounts shall retain their character for all federal income tax purposes (including sections 902, 959, 960, 961, 1248, and 6038).

(3) *Recognition of foreign currency gain or loss on previously taxed earnings and profits on the transition date.* Gain or loss is recognized under section 986(c) as if all previously taxed earnings and profits as determined on the transition date, if any, were distributed on such date. Such gain or loss shall be reduced by any foreign currency gain and increased by any foreign currency loss that was recognized under section 986(c) with respect to distributions of previously taxed earnings and profits during the look-back period. Such amount shall be characterized in accordance with section 986(c) and taken into account in accordance with the rules of paragraph (c)(1) of this section.

(4) *Subpart F income adjustment.* Subpart F income in a separate category shall be determined under §1.985-3 for each look-back year. For this purpose, the opening DASTM balance sheet shall be determined under §1.985-5. The sum of the difference (positive or negative) between the amount computed pursuant to §1.985-3 and amount that was included in income for each year shall be taken into account in the taxable year of change pursuant to paragraph (c)(1) of this section. Such amounts shall retain their character for all federal income tax purposes (including sections 902, 959, 960, 961, 1248, and 6038). For rules applicable if an adjustment under this section results in a loss for the taxable year in a separate category, see section 904(f) and the regulations thereunder. The amount of previously taxed earnings and profits as determined under section 959(c)(2) shall be adjusted (positively or negatively) by the amount taken into account under this paragraph (c)(4) as of the first day of the taxable year of change.

(5) *Foreign tax credit.* A United States shareholder of a CFC shall compute an amount of foreign taxes deemed paid under section 960 with respect to any positive adjustments determined under para-

graph (c) of this section. The amount of foreign tax deemed paid shall be computed with reference to the full amount of the adjustment and to the post-1986 undistributed earnings determined under paragraph (b)(4)(i) and (ii) of this section and the post-1986 foreign income taxes of the CFC on the first day of the taxable year of change (i.e., without taking into account earnings and taxes for the taxable year of change.) For purposes of section 960, the associated taxes in each separate category shall be allocated pro rata among, and deemed paid in, the shareholder's taxable years in which the income is taken into account. (No adjustment to foreign taxes deemed paid in prior years is required solely by reason of a negative adjustment to income under paragraph (c)(1) of this section.)

(d) *QBU branches—(1) In general.* In the case of a QBU branch, the taxpayer shall make the adjustments set forth in paragraphs (d)(2) through (d)(4) of this section. Adjustments under this section shall be taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

(2) *Treatment of certain section 988 transactions—(i) Exchange gain or loss from section 988 transactions unrealized as of the transition date.* A QBU branch shall adjust income by the amount of any unrealized exchange gain or loss that was attributable to a section 988 transaction (as defined in sections 988(c)(1)(A), (B), and (C)) that was denominated in terms of (or determined by reference to) the dollar and was held by the QBU branch on the transition date. Such gain or loss shall be computed as if recognized on the transition date and shall be reduced by any gain and increased by any loss recognized by the QBU branch with respect to such transaction during the look-back period. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (i.e., whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988. Proper adjustments shall be made to account for gain or loss taken into account by reason of this paragraph (d)(2). See §1.985-5(f) *Example 1, footnote 1.*

(ii) *Treatment of a section 988 transaction entered into and terminated during*

the look-back period. A QBU branch shall reduce income by the amount of any gain, and increase income by the amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

(3) *Deemed termination income adjustment.* The taxpayer shall realize gain or loss attributable to the QBU branch's equity pool (as stated on the transition date) under the principles of section 987, computed as if the branch terminated on the transition date. Such amount shall be reduced by section 987 gain and increased by section 987 loss that was recognized by such taxpayer with respect to remittances during the look-back period.

(4) *Branch income adjustment.* Branch income in a separate category shall be determined under §1.985-3 for each look-back year. For this purpose, the opening DASTM balance sheet shall be determined under §1.985-5. The sum of the difference (positive or negative) between the amount computed pursuant to §1.985-3 and amount taken into account for each year shall be taken into account in the taxable year of change pursuant to paragraph (d)(1) of this section. Such amounts shall retain their character for all federal income tax purposes.

(5) *Opening balance sheet.* The opening balance sheet of a QBU branch for the taxable year of change shall be determined as if the branch had changed its functional currency to the dollar by applying §1.985-5(c) on the transition date and had translated its assets and liabilities under §1.985-3 during the look-back period.

(e) *Effective date.* This section is effective for taxable years beginning after April 6, 1998. However, a taxpayer may choose to apply this section to all open taxable years beginning after December 31, 1986, provided each person, and each QBU branch of a person, that is related (within the meaning of §1.985-2(d)(3)) to the taxpayer also applies this section rules.

Michael P. Dolan,
Deputy Commissioner of
Internal Revenue.

Approved February 11, 1998.

Donald C. Lubick,
Assistant Secretary of
the Treasury.

Section 1.1502-3: Regulations

26 CFR 1.1502-3: Consolidated investment credit.

T.D. 8766

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Consolidated Returns— Limitations on the Use of Certain Credits; Overall Foreign Loss Accounts

AGENCY: Internal Revenue Service
(IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary amendments to the consolidated return regulations. The temporary amendments modify the date temporary regulations apply as published in the **Federal Register** on January 12, 1998, relating to the use of tax credits of a consolidated group and its members. The amendments provide guidance to consolidated groups that have a taxable year beginning on or after January 1, 1997, for which the income tax return is due on or before March 13, 1998. The text of the temporary regulations also serves as the text of REG-104062-97, page 20 of this Bulletin.

DATES: *Effective dates:* These amendments are effective March 13, 1998.

Applicability dates: For dates of application, see the **Effective Dates** portion of the preamble under SUPPLEMENTARY INFORMATION.

FOR FURTHER INFORMATION CONTACT: Roy A. Hirschhorn, (202) 622-7770.

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On January 12, 1998, the IRS and Treasury published in the **Federal Register**

final, temporary and proposed regulations (the January 12, 1998, regulations) relating to limitations on the use of certain tax credits and related attributes by corporations filing consolidated income tax returns. In general, the January 12, 1998, regulations relate to the separate return limitation year provisions (and certain consolidated return changes in ownership) for general business credits, alternative minimum tax credits, foreign tax credits and overall foreign loss accounts. The January 12, 1998, regulations were generally applicable to consolidated return years beginning on or after January 1, 1997. IRS and Treasury have determined that the appropriate effective date of those regulations should be for consolidated return years for which the due date (without extensions) of the income tax return is after March 13, 1998. In lieu of applying this effective date, a consolidated group may choose to apply the effective date provisions as published in the January 12, 1998, regulations. Taxpayers making this choice must apply all of those effective date provisions for all relevant years. Thus, such taxpayers may not choose to apply one provision of the January 12, 1998, regulations and not another.

Effective Dates

The temporary amendments are applicable to consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. As explained in the Background portion of this preamble, taxpayers may instead choose to apply the effective date provisions of the January 12, 1998, regulations (i.e., generally taxable years beginning on or after January 1, 1997).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations principally affect corporations filing consolidated federal income tax returns that have carryover or carryback of credits from

separate return limitation years. Available data indicates that many consolidated return filers are large companies (not small businesses). In addition, the data indicates that an insubstantial number of consolidated return filers that are smaller companies have credit carryovers or carrybacks, and thus even fewer of these filers have credit carryovers or carrybacks that are subject to the separate return limitation year rules. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. It has also been determined that under section 553(d) of the Administrative Procedure Act (5 U.S.C. chapter 5) these regulations should be effective immediately because they involve the applicability of regulations that modify the limitations on the use of certain tax attributes for taxable years beginning on or after January 1, 1997. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking accompanying these regulations is being sent to the Small Business Administration for comment on their impact on small businesses.

Drafting Information

The principal author of these regulations is Roy A. Hirschhorn of the Office of Assistant Chief Counsel (Corporate). Other personnel from the IRS and Treasury participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1502-3 is amended by revising paragraphs (c)(3), (d)(2) and (e)(3) to read as follows:

§1.1502-3 Consolidated investment credit.

* * * * *

(c) * * *

(3) *Special effective date.* This paragraph (c) applies to consolidated return

years for which the due date of the income tax return (without extensions) is on or before March 13, 1998. See §1.1502-3T(c) for the rule that limits the group's use of a section 38 credit carryover or carryback from a SRLY for a consolidated return year for which the due date of the income tax return (without extensions) is after March 13, 1998. For taxable years not subject to §1.1502-3T(c), prior law applies. See §1.1502-3(c) in effect prior to January 12, 1998 (§1.1502-3(c) as contained in the 26 CFR part 1 edition revised April 1, 1997) for prior law. See also §1.1502-3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (c) inapplicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

(d) *Examples.* * * *

(2) *Example (2)* and *Example (3)* of this paragraph (d) do not apply to consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. For consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, see §1.1502-3T(d).

(e) * * *

(3) *Special effective date.* This paragraph (e) applies only to a consolidated return change of ownership that occurred during a consolidated return year for which the due date of the income tax return (without extensions) is on or before March 13, 1998. See §1.1502-3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (e) inapplicable if the consolidated return change of ownership occurred on or after January 1, 1997, and during a consolidated return year for which the due date of the income tax return (without extensions) is on or before March 13, 1998).

* * * * *

Par. 3. Section 1.1502-3T is amended by revising paragraphs (c)(3) and (d)(2) and adding a new paragraph (c)(4) to read as follows:

§1.1502-3T Consolidated investment credit (temporary).

* * * * *

(c) * * *

(3) *Effective date.* This paragraph (c) applies to consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. However, a group does not take into account a consolidated taxable year for which the due date of the income tax return (without extensions) is on or before March 13, 1998, in determining a member's (or subgroup's) contributions to the consolidated section 38(c) limitation under this paragraph (c). See also §1.1502-3(c).

(4) *Optional effective date of January 1, 1997.* In lieu of paragraphs (c)(3) and (d)(2) of this section and §§1.1502-3(c)(3), (d)(2) and (e)(3) (relating to the general business credit), 1.1502-4(f)(3) and (g)(3), 1.1502-4T(f) and (g)(3) (relating to the foreign tax credit), 1.1502-9(a) (the next to last sentence), 1.1502-9T(b)-(1)(v) (relating to overall foreign losses), and 1.1502-55T(h)(4)(iii)(C) (relating to the alternative minimum tax credit), a consolidated group may apply such paragraphs as they appear in 1998-10 I.R.B. 23 (see §601.601(d)(2) of this chapter). A consolidated group making this choice must apply all such paragraphs for all relevant years.

(d) * * *

(2) This paragraph (d) applies to consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. See also §1.1502-3(d) for years for which the due date of the income tax return (without extensions) is on or before March 13, 1998.

* * * * *

Par. 4. Section 1.1502-4 is amended by revising paragraphs (f)(3) and (g)(3) to read as follows:

§1.1502-4 Consolidated foreign tax credit.

* * * * *

(f) * * *

(3) *Special effective date ending SRLY limitation.* See §1.1502-4T(f) for the rule that ends the SRLY limitation with respect to foreign tax credits for consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. See also §1.1502-3T(c)(4) for an optional effective

date rule (generally making the rules of this paragraph (f) inapplicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

(g) * * *

(3) *Special effective date for CRCO limitation.* See §1.1502-4T(g)(3) for the rule that ends the CRCO limitation with respect to a consolidated return change of ownership that occurs on or after the first day of a taxable year for which the due date of the income tax return (without extensions) is after March 13, 1998. See also §1.1502-3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (g) inapplicable if the consolidated return change of ownership occurred on or after January 1, 1997, and during a consolidated return year for which the due date of the income tax return (without extensions) is on or before March 13, 1998).

* * * * *

Par. 5. Section 1.1502-4T is amended by revising paragraphs (f) and (g)(3) to read as follows:

§1.1502-4T Consolidated foreign tax credit (temporary).

* * * * *

(f) *Limitation on unused foreign tax carryover or carryback from separate return limitation years.* Section 1.1502-4(f) does not apply for consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. For consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, a group shall include an unused foreign tax of a member arising in a SRLY without regard to the contribution of the member to consolidated tax liability for the consolidated return year. See also §1.1502-3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (f) applicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

* * * * *

(g)(3) *Special effective date for CRCO limitation.* Section 1.1502-4(g) applies only to a consolidated return change of ownership that occurred during a consolidated return year for which the due date of the income tax return (without extensions) is on or before March 13, 1998. See also §1.1502-3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (g)(3) applicable if the consolidated return change of ownership occurred on or after January 1, 1997, and during a consolidated return year for which the due date of the income tax return (without extensions) is on or before March 13, 1998).

Par. 6. In §1.1502-9, paragraph (a) is amended by removing the last sentence and adding two sentences in its place to read as follows:

§1.1502-9 Application of overall foreign loss recapture rules to corporations filing consolidated returns.

(a) * * * See §1.1502-9T(b)(1)(v) for the rule that ends the separate return limitation year limitation for consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. See also §1.1502-3T(c)(4) for an optional effective date rule (generally making the rules of paragraphs (b)(1)(iii) and (iv) of this section inapplicable for a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

* * * * *

Par. 7. Section 1.1502-9T is amended by revising paragraph (b)(1)(v) to read as follows:

§1.1502-9T Application of overall foreign loss recapture rules to corporations filing consolidated returns (temporary).

* * * * *

(b)(1)(v) *Special effective date for SRLY limitation.* Sections 1.1502-9(b)(1)(iii) and (iv) apply only to consolidated return years for which the due date of the income tax return (without extensions) is on or before March 13, 1998. For consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, the rules of §1.1502-9(b)(1)(ii) shall apply to overall foreign losses from separate return years that are separate return limitation years. For purposes of applying §1.1502-9(b)(1)(ii) in such years, the group treats a member with a balance in an overall foreign loss account from a separate return limitation year on the first day of the first consolidated return year for which the due date of the income tax return (without extensions) is after March 13, 1998, as a corporation joining the group on such first day. An overall foreign loss that is part of a net operating loss or net capital loss carryover from a separate return limitation year of a member that is absorbed in a consolidated return year for which the due date of the income tax return (without extensions) is after March 13, 1998, shall be added to the appropriate consolidated overall foreign loss account in the year that it is absorbed. For consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, similar principles apply to overall foreign losses when there has been a consolidated return change of ownership (regardless of when the change of ownership occurred). See also §1.1502-3T(c)(4) for an optional effective date rule (generally making this paragraph (b)(1)(v) applicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

* * * * *

Par. 8. Section 1.1502-55T is amended by revising paragraph (h)(4)(iii)(C) to read as follows:

§1.1502-55T Computation of alternative minimum tax of consolidated groups (temporary).

* * * * *

(h)(4) * * *

(iii) * * *

(C) *Effective date.* This paragraph (h)(4)(iii) applies to consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. However, a group does not take into account a consolidated taxable year for which the due date of the income tax return (without extensions) is on or before March 13, 1998, in determining a member's (or subgroup's) contributions to the consolidated section 53(c) limitation under paragraph (h)(4)(iii) of this section. See §1.1502-3T(c)(4) for an optional effective date rule (generally making this paragraph (h)(4)(iii) applicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

Michael P. Dolan,
Deputy Commissioner of
Internal Revenue.

Approved March 9, 1998.

Donald C. Lubick,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on March 13, 1998, at 8:45 a.m., and published in the Federal Register for March 16, 1998, 63 F.R. 12641)

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Consolidated Returns— Limitations on the Use of Certain Credits and Related Tax Attributes

REG-104062-97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In T.D. 8766 on page 17 of this Bulletin, the IRS is issuing temporary regulations that relate to the use of certain tax credits and losses of a consolidated group and its members. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of topics to be discussed at the public hearing scheduled for May 7, 1998, at 10 a.m., must be received by April 13, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R [REG-104062-97], room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R [REG-104005-98], Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the Home Page or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing has been scheduled for May 7, 1998, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, in general, Roy A. Hirschhorn (202) 622-7770; concerning submissions and

the hearing, Mike Slaughter (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

T.D. 8766 amends the Income Tax Regulations (26 CFR part 1) relating to section 1502. The temporary regulations provide rules that relate to the use of certain tax credits and related tax attributes of a consolidated group and its members. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations principally affect corporations filing consolidated federal income tax returns that have carryover or carryback of credits from separate return limitation years. Available data indicates that many consolidated return filers are large companies (not small businesses). In addition, the data indicates that an insubstantial number of consolidated return filers that are smaller companies have credit carryovers or carrybacks, and thus even fewer of these filers have credit carryovers or carrybacks that are subject to the separate return limitation year rules. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration

will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be made available for public inspection and copying.

A public hearing has been scheduled for May 7, 1998, at 10 a.m., in room 2615. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics (signed original and eight (8) copies) to be discussed by April 13, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Roy A. Hirschhorn of the Office of Assistant Chief Counsel (Corporate). Other personnel from the IRS and Treasury participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1502-3 also issued under 26 U.S.C. 1502.

Section 1.1502-4 also issued under 26 U.S.C. 1502.

Section 1.1502-9 also issued under 26 U.S.C. 1502. * * *

Section 1.1502-55 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502-3, as proposed to be amended at 63 F.R. 1804, January

12, 1998, is amended by revising paragraphs (c)(3) and (d)(2) and adding paragraph (c)(4) to read as follows:

§1.1502-3 Consolidated investment credit.

* * * * *

(c) * * *

(3) and (4) [The text of proposed paragraphs (c)(3) and (4) of this section is the same as the text of §1.1502-3T(c)(3) and (4) published in T.D. 8766.]

(d) * * *

(2) [The text of proposed paragraph (d)(2) of this section is the same as the text of §1.1502-3T(d)(2) published in T.D. 8766.]

* * * * *

Par. 3. Section 1.1502-4, as proposed to be amended at 63 F.R. 1804, January 12, 1998, is amended by revising paragraphs (f)(3) and (g)(3) to read as follows:

§1.1502-4 Consolidated foreign tax credit.

* * * * *

(f) * * *

(3) [The text of proposed paragraph (f)(3) of this section is the same as the text of §1.1502-4T(f)(3) published in T.D. 8766.]

(g) * * *

(3) [The text of proposed paragraph (g)(3) of this section is the same as the text of §1.1502-4T and (g)(3) published in T.D. 8766.]

* * * * *

Par. 4. Section 1.1502-9, as proposed to be amended at 63 F.R. 1804, January 12, 1998, is amended by revising paragraph (b)(1)(v) to read as follows:

§1.1502-9 Application of overall foreign losses recapture rules to corporations filing consolidated returns.

* * * * *

(b) * * *

(1) * * *

(v) [The text of proposed paragraph (b)(1)(v) of this section is the same as the text of §1.1502-9T(b)(1)(v) published in T.D. 8766.]

* * * * *

Par. 5. Section 1.1502-55, as proposed to be added at 57 F.R. 62257, December 30, 1992, and amended at 63 F.R. 1804, January 12, 1998, is further amended by revising paragraph (h)(4)(iii)(C) to read as follows as follows:

§1.1502-55 Computation of alternative minimum tax of consolidated groups.

* * * * *

(h) * * *

(4) * * *

(iii) * * *

(C) [The text of proposed paragraph (h)(4)(iii)(C) of this section is the same as the text of §1.1502-55T(h)(4)(iii)(C) published in T.D. 8766.]

* * * * *

Michael P. Dolan,
Deputy Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on March 13, 1998, at 8:45 a.m., and published in the Federal Register for March 16, 1998, 63 F.R. 12717)

Notice of Proposed Rulemaking
and Notice of Public Hearing

Guidance Under Subpart F
Relating to Partnerships and
Branches

REG-104537-97

AGENCY: Internal Revenue Service
(IRS), Treasury.

ACTION: Notice of proposed rulemaking, notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: The IRS and Treasury Department are issuing temporary regulations, published in T.D. 8767, page 4 of this Bulletin, relating to the treatment under subpart F of certain branches of a controlled foreign corporation (CFC) that are treated as separate entities for foreign tax purposes. The text of the temporary regulations also serves as the text of these proposed regulations. In addition, this document contains proposed regulations relating to the treatment of a CFC's distributive share of partnership income. This document also provides notice of a

public hearing on these proposed regulations.

DATES: Written comments must be received by June 24, 1998. Outlines of oral comments to be discussed at the public hearing scheduled for July 15, 1998, must be received by June 24, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-104537-97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (REG-104537-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Valerie Mark, (202) 622-3840; concerning submissions and the hearing, Mike Slaughter (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. In General

In these proposed regulations, and in temporary regulations published in T.D. 8767, the Treasury and IRS set forth a framework for dealing with the issues posed by the use of certain entities which are regarded as fiscally transparent for the purposes of U.S. tax law, with regard to the application of subpart F of the Internal Revenue Code.

Subpart F was enacted by Congress to limit the deferral of U.S. taxation of certain income earned outside the United States by foreign corporations controlled by U.S. persons. Limited deferral was retained after the enactment of subpart F to protect the competitiveness of controlled foreign corporations (CFCs) doing business overseas. See S. Rep. No. 1881,

87th Cong., 2d Sess. 78–80 (1962). This limited deferral furthers the objective of allowing a CFC engaged in an active business, and located in a foreign country for appropriate economic reasons, to compete in a similar tax environment with non-U.S. owned corporations located in the same country.

Conversely, one of the purposes of subpart F is to prevent CFCs from converting active income that is not easily moveable and is earned in a jurisdiction in which a business is located for non-tax reasons into passive, easily moveable income shifted to a lower tax jurisdiction primarily for tax avoidance. Moreover, when subpart F was first enacted it was realized that related person transactions can be easily manipulated to reduce both United States and foreign taxes. Consequently, in enacting subpart F, Congress provided that transactions of CFCs that involve related persons generally give rise to subpart F income with certain enumerated exceptions.

Hybrid branches, by definition, are not regarded as fiscally transparent under foreign law. Thus, they are particularly well suited for the type of tax avoidance described above. In light of the recent proliferation of hybrid branches, Treasury and the IRS believe that it is appropriate to consider the issues related to transactions involving hybrid branches, or other hybrid entities, under subpart F.

The use of other organizations that are fiscally transparent for U.S. tax purposes, including partnerships, raise additional issues. These entities may or may not be fiscally transparent under foreign law. In the context of subpart F, issues similar to those raised in connection with hybrid branches are raised in connection with partnerships. (Other fiscally-transparent entities, such as grantor trusts, will be the subject of guidance issued in conjunction with the finalization of regulations under section 672(f).)

The entity classification regulations of §§301.7701–1 through 301.7701–3 (the check-the-box regulations) make entity classification generally elective, in part so that taxpayers can choose a tax status consistent with their business objectives. This administrative provision, however, was not intended to change substantive law. Particularly in the international area, however, the ability to more easily

achieve fiscal transparency can lead to inappropriate results under certain substantive international provisions of the Code. Thus, the Treasury and the IRS believe that it is necessary to provide additional guidance regarding the use of hybrid entities in the international context. See preamble to T.D. 8697, 61 Fed. Reg. 66585 (December 18, 1996).

II. *Controlled Foreign Corporation's Distributive Share of Partnership Income*

In *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), vacating and remanding 104 T.C. 105 (1995), a Cayman Islands partnership with a Cayman Islands CFC partner earned commission income from selling footwear purchased in Brazil on behalf of the CFC's U.S. parent. This commission income would have been subpart F income, specifically foreign base company sales income under section 954(d), to the CFC if it had earned this commission income directly and under the same circumstances in which the partnership earned this income. The Tax Court held that the CFC's distributive share of this commission income was subpart F income. The Eighth Circuit, vacating and remanding the Tax Court's decision, held that the CFC's distributive share of this commission income was not subpart F income.

In response to the Eighth Circuit's opinion, the IRS announced that it intended to issue regulations under subpart F to confirm its position that whether a CFC partner's distributive share of partnership income is subpart F income generally is determined at the CFC partner level. See Notice 96–39 (1996–2 C.B. 209).

These proposed regulations would address the treatment of a CFC partner's distributive share of partnership income under subpart F. These regulations apply to all categories of subpart F income, not only to foreign base company sales income, which was at issue in *Brown Group*. These regulations would provide specific rules that apply to determine a CFC partner's distributive share of foreign personal holding company income, foreign base company sales income, foreign base company services income, and earnings invested in United States property.

The approach taken by these proposed regulations is based on the provisions of

subchapter K and subpart F and the policies underlying those provisions. The legislative history of subchapter K indicates that a partnership distributive share should be characterized by using the approach that best serves the Code or regulations section at issue. Subpart F limits deferral of U.S. income tax on common types of passive income received by CFCs, as well as on certain other types of easily moveable income. To allow a CFC to avoid subpart F treatment for items of income by the simple expedient of receiving them as distributive shares of partnership income, rather than directly, is contrary to the intent of subpart F.

Explanation of Provisions

Under these proposed regulations, income and deductions would be characterized at the partnership level. If any part of the partnership's gross income would be subpart F income if received directly by partners that are CFCs, it must be separately stated under section 702. Comments are requested as to whether this rule should not apply for ownership levels under certain thresholds. The regulations under section 702 also would be clarified to expressly provide that an item must be separately stated when, if separately taken into account by any partner, the separately stated item would affect the income tax liability of that partner or any other person. This clarification incorporates in the regulations the position of the IRS. See Rev. Rul. 86–138 (1986–2 C.B. 84) (holding that a subsidiary partnership in a multi-tiered arrangement must separately state items which, if separately taken into account by any partner of any partnership in the multi-tiered arrangement, would affect the income tax liability of that partner).

The regulations under section 952 would also be clarified to expressly include within the definition of subpart F income a CFC's distributive share of any item of gross income of a partnership to the extent the income would have been subpart F income if received by the CFC partner directly. The proposed regulations would further provide that, generally, in determining whether a distributive share of partnership income is subpart F income, whether an entity is a related person and whether activity takes place in or outside the CFC's country of incorporation is determined with respect to the CFC

partner and not the partnership. Thus, on the Brown Group facts, the income in issue would retain its character as commission income from the sale of shoes purchased in Brazil on behalf of a U.S. parent for sale in the U.S. It would be determined at the CFC partner level that the shoes were manufactured and sold for use outside of the CFC's country of incorporation (Cayman Islands), and that the U.S. parent was a related person with respect to the CFC. Thus, the income would be foreign base company sales income.

The proposed and temporary regulations also address the question of whether a CFC's distributive share of partnership income can qualify for the exceptions from foreign personal holding company income treatment. Some of these exceptions are based on whether the income is earned in a transaction with a related person that is incorporated, or uses property, in the CFC's country of incorporation. The proposed and temporary regulations address the application of those exceptions. Other exceptions are based on the activities performed by the CFC in connection with the property through which it earns the income. The proposed regulations would provide that the exceptions requiring activity will generally apply if the exception would have applied to the income had the partnership itself been a CFC. This requirement is not met if the partnership can qualify for the exception only by taking into account the separate activities of its partners (e.g., the partnership owns property and the CFC provides the management services).

These proposed regulations would amend the rules regarding the application of the manufacturing exception of §1.954-3(a)(4). The regulations would clarify the Service's current position that, in general, a controlled foreign corporation can apply the exception only if it has performed the manufacturing activities itself. Thus, manufacturing activities of a contract manufacturer will not be taken into account.

Nevertheless, the manufacturing activities of a partnership may be taken into account under the distributive share rules when the partnership sells the property that it manufactures. These proposed regulations would clarify how the manufacturing exception of §1.954-3(a)(4) applies in the context of the distributive

share rules. As previously noted, the general rules would provide that income that could be foreign base company sales income at the CFC partner level is separately stated and that determinations as to relatedness and the relevant country are made at the partner level. Consistent with the framework outlined above, these regulations would allow a CFC's distributive share of sales income to be excluded, under the manufacturing exception of §1.954-3(a)(4), when the partnership's activities with respect to the property it sells (without regard to the CFC partner's activities) would be sufficient to constitute manufacturing.

Treasury and the IRS are considering applying foreign base company sales income rules in the context of manufacturing branches of partnerships. Comments are requested as to the appropriate scope of such rules.

Under the general rule for determining whether a CFC partner's distributive share includes subpart F income, a CFC partner's distributive share of partnership income earned from performing services for or on behalf of a person that is a related person with respect to the CFC partner will be foreign base company services income. These proposed regulations also would describe how the substantial assistance rule of §1.954-4(b)(1)(iv) applies when the CFC earns services income through a partnership. When the partnership is performing services for a person unrelated to the CFC partner but the CFC partner provides substantial assistance to the partnership contributing to the performance of those services, the partner and the partnership would be regarded as separate entities and the substantial assistance provided from the CFC to the partnership would cause the CFC's distributive share of the services income to be treated as foreign base company services income. Treasury and the IRS are considering applying similar principles to branches. Comments are requested on this issue.

Finally, consistent with Rev. Rul. 90-112 (1990-2 C.B. 186), the regulations would provide that, for purposes of section 956, a CFC partner's investment in U.S. property includes the U.S. property held by a partnership to the extent of the CFC's ownership interest in the partnership. Comments are requested on this issue.

III. Hybrid Branches

Temporary regulations, published in T.D. 8767, amend the Income Tax Regulations (26 CFR part 1) relating to sections 952 and 954 by adding rules relating to the treatment under subpart F of certain branches of a CFC or a partnership in which a CFC is a partner that are treated as separate entities for foreign tax purposes. The text of those temporary regulations also serves as the text of the proposed regulations. The preamble to the temporary regulations explains the reasons for the addition.

IV. Proposed Effective Date

These regulations are proposed to apply for taxable years of a controlled foreign corporation beginning on or after the date the final regulations are published in the Federal Register. For prior periods, the IRS will rely on principles and authorities under subpart F and subchapter K to apply an aggregate approach, including §1.701-2(e) and (f) of the regulations for periods for which it is effective.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for July 15, 1998, at 10 a.m., in room 2615, Internal Revenue Building, 1111

Constitution Avenue NW, Washington DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by June 24, 1998, and submit an outline of topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by June 24, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Valerie Mark of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2 Section §1.702–1 is amended as follows:

1. Paragraph (a)(8)(ii) is revised.
2. A new paragraph (c)(1)(v) is added.

The addition and revision read as follows:

§1.702–1 Income and credits of partner.

(a) * * *

(8) * * *

(ii) Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if

that partner did not take the item into account separately. Thus, if any partner is a controlled foreign corporation, as defined in section 957, items of income that would be gross subpart F income if taken into account by the controlled foreign corporation must be separately stated for all partners. Under section 911(a), if any partner is a bona fide resident of a foreign country who may exclude from gross income the part of the partner's distributive share which qualifies as earned income as defined in section 911(b), the earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 183 (relating to activities not engaged in for profit) and the recomputation of tax thereunder for any partner.

* * * * *

(c) * * *

(1) * * *

(v) In determining whether the *de minimis* or full inclusion rules of section 954(b)(3) apply.

* * * * *

Par. 3. In §1.952–1, paragraphs (b) through (f) are redesignated as paragraphs (c) through (g), respectively, and a new paragraph (b) is added to read as follows:

§1.952–1 Subpart F income defined.

* * * * *

(b) *Treatment of distributive share of partnership income—(1) In general.* A controlled foreign corporation's distributive share of any item of income of a partnership is income that falls within a category of subpart F income described in section 952(a) to the extent the item of income would have been income in such category if received by the controlled foreign corporation directly. For specific rules regarding the treatment of a distributive share of partnership income under certain provisions of subpart F, see §§1.954–1(g); 1.954–2(a)(5); 1.954–3(a)(6); 1.954–4(b)(2)(iii); and 1.954–6(g).

(2) *Example.* The application of this paragraph (b) may be illustrated by the following example.

Example. CFC, a controlled foreign corporation, is an 80-percent partner in PRS, a foreign partner-

ship. PRS earns \$100 of interest income that is not export financing interest, as defined in section 954(c)(2)(B), from a person unrelated to CFC. This interest income would have been foreign personal holding company income to CFC, under section 954(c), if it had received this income directly. Accordingly, CFC's distributive share of this interest income, \$80, is foreign personal holding company income.

* * * * *

Par. 4. Section 1.954–1 is amended as follows:

1. Paragraphs (c)(1)(i)(A) through (D) are redesignated as (c)(1)(i)(A)(I) through (4), respectively.

2. A new paragraph heading for newly designated paragraph (c)(1)(i)(A) is added.

3. New paragraphs (c)(1)(i)(B) through (E) are added.

4. Paragraph (g) is added.

The additions read as follows:

§1.954–1 Foreign base company income.

* * * * *

(c) * * *

(1) * * *

(i) *Deductions against gross foreign base company income—(A) In general.*
* * *

* * * * *

(B) through (E) [The text of the proposed paragraphs (c)(1)(i)(B) through (E) is the same as the text of §1.954–1T(c)(1)(i)(B) through (E) published in T.D. 8767.]

* * * * *

(g) *Distributive share of partnership income—(1) Application of related person and country of organization tests.* Unless otherwise provided, to determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been subpart F income if received by it directly, under §1.952–1(b), if a provision of subpart F requires a determination of whether an entity is a related person, within the meaning of section 954(d)(3), or whether an activity occurred within or outside the country under the laws of which the controlled foreign corporation is created or organized, this determination shall be made by reference to such controlled foreign corporation and not by reference to the partnership.

(2) *Example.* The application of paragraph (g)(1) of this section is illustrated by the following example:

Example. (i) CFC1, a controlled foreign corporation organized in Country A, is an 80-percent partner in Partnership, a partnership organized in Country B. CFC2, a controlled foreign corporation organized in Country B, owns the remaining 20 percent interest in Partnership. CFC1 and CFC2 are owned by a common U.S. parent, USP. CFC2 manufactures Product A in Country B. Partnership earns sales income from purchasing Product A from CFC2 and selling it to third parties located in Country B that are not related persons with respect to CFC1 or CFC2. For purposes of determining whether CFC1's distributive share of Partnership's sales income is foreign base company sales income under section 954(d), CFC1 is treated as if it purchased Product A from CFC2 and sold it to third parties in Country B. Under section 954(d)(3), CFC2 is a related person with respect to CFC1. Thus, with respect to CFC1, the sales income is deemed to be derived from the purchase of personal property from a related person. Because the property purchased is both manufactured and sold for use outside of Country A, CFC1's country of organization, CFC1's distributive share of the sales income is foreign base company sales income.

(ii) For purposes of determining whether CFC2's distributive share of Partnership's sales income is foreign base company sales income, CFC2 is treated as if it directly sold Product A to third parties within Country B. Therefore, Product A is both manufactured and sold for use within CFC2's country of organization. Thus, CFC2's distributive share of Partnership's sales income is not foreign base company sales income.

Par. 5. In §1.954-2, paragraph (a)(5) and (a)(6) are added to read as follows:

§1.954-2 Foreign personal holding company income.

(a) * * *

(5) *Special rules applicable to distributive share of partnership income*—(i) [The text of the proposed paragraph (a)(5)(i) is the same as the text of §1.954-2T(a)(5) published in T.D. 8767.]

(ii) *Certain other exceptions applicable to foreign personal holding company income.* To determine the extent to which a controlled foreign corporation's distributive share of an item of income of a partnership is foreign personal holding company income, the exceptions contained in sections 954(c)(2) and §1.954-2(b)(2) and (6), (e)(1)(ii), (f)(1)(ii), (g)(2)(ii), and (h)(3)(ii), shall apply only if any such exception would have applied to exclude the income from foreign personal holding company income if the controlled foreign

corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person.

(iii) [The text of the proposed paragraph (a)(5)(iii) is the same as the text of §1.954-2T(a)(5)(iii) published in T.D. 8767.]

(6) *Special rules applicable to exceptions from foreign personal holding company income treatment in circumstances involving hybrid branches*—(i) [The text of the proposed paragraph (a)(6)(i) is the same as the text of §1.954-2T(a)(6) published in T.D. 8767.]

* * * * *

Par. 6. Section 1.954-3 is amended as follows:

1. The second sentence of paragraph (a)(4)(i) is revised.

2. The first sentence of paragraph (a)(4)(ii) is revised.

3. Paragraph (a)(6) is added.

The revisions and addition read as follows:

§1.954-3 Foreign base company sales income.

(a) * * *

(4) * * *

(i) * * * A controlled foreign corporation (selling corporation) will be considered, for purposes of this paragraph (a)(4), to have manufactured, produced, or constructed personal property that it sells if, as a result of the operations conducted by such selling corporation in connection with the property that it purchased and sold, the property sold is in effect not the property that it purchased. * * *

(ii) * * * If, prior to its sale of property that it has purchased, a selling corporation substantially transforms the property, the selling corporation will be treated as having manufactured, produced, or constructed such property. * * *

* * * * *

(6) *Special rule applicable to distributive share of partnership income*—(i) *In general.* To determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been foreign

base company sales income if received by it directly, under §1.952-1(b), the property sold will be considered to be manufactured, produced or constructed by the controlled foreign corporation within the meaning of paragraph (a)(4) of this section only if the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person.

* * * * *

Par. 7. In §1.954-4, paragraph (b)(2)(iii) is added to read as follows:

§1.954-4 Foreign base company services income.

* * * * *

(b) * * *

(2) * * *

(iii) *Special rule applicable to distributive share of partnership income.* A controlled foreign corporation's distributive share of a partnership's services income will be deemed to be derived from services performed for or on behalf of a related person, within the meaning of section 954(e)(1)(A), if the partnership is a related person with respect to the controlled foreign corporation, under section 954(d)(3), and, in connection with the services performed by the partnership, the controlled foreign corporation provided assistance that would have constituted substantial assistance contributing to the performance of such services, under paragraph (b)(2)(ii) of this section, if furnished to the controlled foreign corporation by a related person.

* * * * *

Par. 8. Section 1.954-9 is added to read as follows:

§1.954-9 Hybrid branches.

[The text of this proposed section is the same as the text of §1.954-9T published in T.D. 8767.]

Par. 9. In §1.956-2, paragraph (a)(3) is added to read as follows:

§1.956-2 *Definition of United States property.*

(a) * * *

(3) For purposes of section 956, if a controlled foreign corporation is a partner in a partnership that owns property that would be United States property, within the meaning of paragraph (a)(1) of this section, if owned directly by the controlled foreign corporation, the controlled foreign corporation will be treated as holding an interest in the property equal to its ownership interest in the partnership and such ownership interest will be treated as an interest in United States property.

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 10. The authority citation for 26 CFR part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 11. Section 301.7701-3 is amended as follows:

1. Paragraph (a) is amended by adding a sentence at the end of the paragraph.

2. Paragraph (c)(1)(iv) is amended by adding a sentence at the end of the paragraph.

The additions read as follows:

§301.7701-3 *Classification of certain business entities.*

(a) [The text of the proposed paragraph (a) of this section is the same as the text of §301.7701-3T(a) published in T.D. 8767.]

* * * * *

(c) * * *

(1) * * *

(iv) [The text of the proposed paragraph (c)(1)(iv) of this section is the same as the text of §301.7701-3T(c)(1)(iv) published in T.D. 8767.]

* * * * *

Michael P. Dolan,
*Deputy Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on March 23, 1998, 12:58 p.m., and published in the issue of the Federal Register for March 26, 1998, 63 F.R. 14669)

Notice of Proposed Rulemaking and Notice of Public Hearing

Allocation and Sourcing of Income and Deductions Among Taxpayers Engaged in a Global Dealing Operation

REG-208299-90

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed rules for the allocation among controlled taxpayers and sourcing of income, deductions, gains and losses from a global dealing operation; rules applying these allocation and sourcing rules to foreign currency transactions and to foreign corporations engaged in a U.S. trade or business; and rules concerning the mark-to-market treatment resulting from hedging activities of a global dealing operation. These proposed rules affect foreign and domestic persons that are participants in such operations either directly or indirectly through subsidiaries or partnerships. These proposed rules are necessary to enable participants in a global dealing operation to determine their arm's length contribution to a global dealing operation. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by June 4, 1998. Outlines of oral comments to be discussed at the public hearing scheduled for July 9, 1998, must be received by June 18, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-208299-90), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-208299-90), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, D.C. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly

to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_reg/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations in general, Ginny Chung of the Office of Associate Chief Counsel(International), (202) 622-3870; concerning the mark-to-market treatment of global dealing operations, Richard Hoge or JoLynn Ricks of the Office of Assistant Chief Counsel (Financial Institutions & Products), (202) 622-3920; concerning submissions and the hearing, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance officer, T:FS:FP, Washington, DC 20224. Comments on the collections of information should be received by May 5, 1998.

Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility; The accuracy of the estimated burden associated with the proposed collections of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in these proposed regulations are in §§1.475(g)–2(b), 1.482–8(b)(3), 1.482–8(c)(3), 1.482–8(d)(3), 1.482–8(e)(5), 1.482–8(e)(6), and 1.863–3(h). The information is required to determine an arm's length price. The collections of information are mandatory. The likely recordkeepers are business or other for-profit institutions.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual recordkeeping burden: 20,000 hours. Estimated average annual burden per recordkeeper is 40 hours. Estimated number of recordkeepers: 500.

Background

In 1990, the IRS issued Announcement 90–106, 1990–38 I.R.B. 29, requesting comments on how the regulations under sections 482, 864 and other sections of the Internal Revenue Code could be improved to address the taxation issues raised by global trading of financial instruments. Section 482 concerns the allocation of income, deductions, credits and allowances among related parties. Section 864 provides rules for determining the income of a foreign person that is “effectively connected” with the conduct of a U.S. trade or business and therefore can be taxed on a net income basis in the United States. Provisions under sections 864(c)(2) and (3) provide rules for determining when U.S. source income is effectively connected income (ECI); section 864(c)(4) provides rules for determining when foreign source income is ECI.

The rules for determining the source of income generally are in sections 861, 862, 863 and 865, and the regulations promulgated under those sections. Section 1.863–7 provides a special rule for in-

come from notional principal contracts, under which such income will be treated as U.S.-source ECI if it arises from the conduct of a U.S. trade or business under principles similar to those that apply under section 864(c)(2). An identical rule applies for determining U.S. source ECI under §1.988–4(c) from foreign exchange gain or loss from certain transactions denominated in a foreign currency.

Because no regulations were issued in response to the comments that were received after Announcement 90–106, there remain a number of uncertainties regarding the manner in which the existing regulations described above apply to financial institutions that deal in financial instruments through one or more entities or trading locations. Many financial institutions have sought to resolve these problems by negotiating advance pricing agreements (APAs) with the IRS. In 1994, the IRS published Notice 94–40, 1994–1 C.B. 351, which provided a generic description of the IRS's experience with global dealing operations conducted in a functionally fully integrated manner. Notice 94–40 specified that it was not intended to prescribe rules for future APAs or for taxpayers that did not enter into APAs. Moreover, Notice 94–40 provided no guidance of any kind for financial institutions that do not conduct their global dealing operations in a functionally fully integrated manner.

Explanation of Provisions

1. Introduction

This document contains proposed regulations relating to the determination of an arm's length allocation of income among participants engaged in a global dealing operation. For purposes of these regulations, the terms “global dealing operation” and “participant” are specifically defined. The purpose of these regulations is to provide guidance on applying the arm's length principle to transactions between participants in a global dealing operation. The general rules in the final regulations under section 482 that provide the best method rule, comparability analysis, and the arm's length range are generally adopted with some modifications to conform these principles to the global dealing environment. In addition, the proposed regulations contain new specified methods with respect to global

dealing operations that replace the specified methods in §§1.482–3 through 1.482–6.

This document also contains proposed regulations addressing the source of income earned in a global dealing operation and the circumstances under which such income is effectively connected to a foreign corporation's U.S. trade or business. The regulations proposed under section 863 generally source income earned in a global dealing operation by reference to the residence of the participant. For these purposes, residence is defined under section 988(a)(3)(B) such that global dealing income may be sourced between separate qualified business units (QBUs) of a single taxpayer or among separate taxpayers who are participants, as the case may be. Exceptions to this general rule are discussed in further detail below.

Proposed amendments to the regulations under section 864 provide that the principles of the proposed section 482 regulations may be applied to determine the amount of income, gain or loss from a foreign corporation's global dealing operation that is effectively connected to a U.S. trade or business of a participant. Similar rules apply to foreign currency transactions that are part of a global dealing operation.

The combination of these allocation, sourcing, and effectively connected income rules is intended to enable taxpayers to establish and recognize on an arm's length basis the contributions provided by separate QBUs to a global dealing operation.

This document also contains proposed regulations under section 475 to coordinate the accounting rules governing the timing of income with the allocation, sourcing, and effectively connected income rules proposed in this document and discussed above.

2. Explanation of Specific Provisions

A. §1.482–1(a)(1)

Section 1.482–1(a)(1) has been amended to include expressly transactions undertaken in the course of a global dealing operation between controlled taxpayers within the scope of transactions covered by section 482. The purpose of this amendment is to clarify that the principles of section 482 apply to evaluate whether global dealing transactions entered into

between controlled taxpayers are at arm's length.

B. §1.482-(a)—General Requirements

Section 1.482-8(a)(1) lists specified methods that may be used to determine if global dealing transactions entered into between controlled taxpayers are at arm's length. The enumerated methods must be applied in accordance with all of the provisions of §1.482-1, including the best method rule of §1.482-1(c), the comparability analysis of §1.482-1(d), and the arm's length range rule of §1.482-1(e). The section further requires that any modifications or supplemental considerations applicable to a global dealing operation set forth in §1.482-8(a)(3) be taken into account when applying any of the transfer pricing methods. Specific modifications to the factors for determining comparability and the arm's length range rule are provided in §1.482-8(a)(3). These modifications and special considerations are discussed in more detail under their respective headings below.

C. §1.482-8(a)(2)—Definitions

Applicable to a Global Dealing Operation

Section 1.482-8(a)(2) defines "global dealing operation," "participant," "regular dealer in securities," and other terms that apply for purposes of these regulations. These definitions supplement the general definitions provided in §1.482-1(i).

The rules of §1.482-8 apply only to a global dealing operation. A "global dealing operation" consists of the execution of customer transactions (including marketing, sales, pricing and risk management activities) in a particular financial product or line of financial products, in multiple tax jurisdictions and/or through multiple participants. The taking of proprietary positions is not included within the definition of a global dealing operation unless the proprietary positions are entered into by a regular dealer in securities in connection with its activities as such a dealer. Thus, a hedge fund that does not have customers is not covered by these regulations. Positions held in inventory by a regular dealer in securities, however, are covered by these regulations even if the positions are unhedged because the dealer is taking a view as to future market changes.

Similarly, lending activities are not included within the definition of a global

dealing operation. However, if a person makes a market in, by buying and selling, asset-backed securities, the income from that activity may be covered by these regulations, regardless of whether the dealer was a party to the loans backing the securities. Therefore, income earned from such lending activities or from securities held for investment is not income from a global dealing operation and is not governed by this section. A security may be held for investment for purposes of this section even though it is not identified as held for investment under section 475.

Activities unrelated to the conduct of a global dealing operation are not covered by these regulations, even if they are accounted for on a mark-to-market basis. Accordingly, income from proprietary trading that is not undertaken in connection with a global dealing operation, and other financial transactions that are not entered into in a dealing capacity are not covered by these proposed regulations. The regulations require that participants engaged in dealing and nondealing activities and/or multiple dealing activities segregate income and expense attributable to each separate dealing operation so that the best method may be used to evaluate whether controlled transactions entered into in connection with a particular dealing activity are priced at arm's length. The regulations also require that taxpayers segregate their dealer activities from their lending, proprietary trading or other investment activities not entered into in connection with a global dealing operation. Comments are solicited on whether the proposed regulations issued under section 475 in this notice of proposed rulemaking are sufficient to facilitate identification of the amount of income that should be subject to allocation under the global dealing regulations.

The term "participant" is defined as a controlled taxpayer that is either a regular dealer in securities within the meaning of §1.482-8(a)(2)(iii), or a member of a group of controlled taxpayers which includes a regular dealer in securities, so long as that member conducts one or more activities related to the activities of such dealer. For these purposes, such related activities are the marketing, sales, pricing, and risk management activities necessary to the definition of a global dealing operation. Additionally, broker-

ing is a related activity that may give rise to participant status. Related activities do not include credit analysis, accounting services, back office services, or the provision of a guarantee of one or more transactions entered into by a regular dealer in securities or other participant. This definition is significant because the transfer pricing methods contained in this section can only be used by participants, and only to evaluate whether compensation attributable to a regular dealer in securities or a marketing, sales, pricing, risk management or brokering function is at arm's length. Whether the compensation paid for other functions performed in the course of a global dealing operation (including certain services and development of intangibles) is at arm's length is determined under the appropriate section 482 regulations applicable to those transactions.

The definition of a global dealing operation does not require that the global dealing operation be conducted around the world or on a twenty-four hour basis. These regulations will apply if the controlled taxpayers, or QBUs of a single taxpayer, operate in the aggregate in more than one tax jurisdiction. It is not necessary, however, for the participants to conduct the global dealing operation in more than one tax jurisdiction. For example, a participant that is resident in one tax jurisdiction may conduct its participant activities in the global dealing operation through a trade or business in another jurisdiction that is the same jurisdiction where the dealer activity of a separate controlled taxpayer takes place. In this situation, the rules of this section apply to determine the allocation of income, gain or loss between the two controlled taxpayers even if all of the income, gain or loss is allocable within the same tax jurisdiction.

The term "regular dealer in securities" is specifically defined in this regulation consistently with the definition of a regular dealer under §1.954-2(a)(4)(iv). Under these proposed regulations, a dealer in physical securities or currencies is a regular dealer in securities if it regularly and actively offers to, and in fact does, purchase securities or currencies from and sell securities or currencies to customers who are not controlled taxpayers in the ordinary course of a trade or

business. In addition, a dealer in derivatives is a regular dealer in securities if it regularly and actively offers to, and in fact does, enter into, assume, offset, assign or otherwise terminate positions in securities with customers who are not controlled entities in the ordinary course of a trade or business. The IRS solicits comments on whether these regulations should be extended to cover dealers in commodities and/or persons trading for their own account that are not dealers.

D. Best Method and Comparability

Consistent with the general principles of section 482, the best method rule applies to evaluate the most appropriate method for determining whether the controlled transactions are priced at arm's length. New specified methods which replace the specified methods of §§1.482-2 through 1.482-6 for a global dealing operation are set forth in §§1.482-8(b) through 1.482-8(f). The comparable profits method of §1.482-5 has been excluded as a specified method for a global dealing operation because of the high variability in profits from company to company and year to year due to differences in business strategies and fluctuations in the financial markets.

The proposed regulations do not apply specific methods to certain trading models, such as those commonly referred to in the financial services industry as "separate enterprise," "natural home," "centralized product management," or "integrated trading." Rather, the proposed regulations adopt the best method rule of §1.482-1(c) to determine the most appropriate transfer pricing methodology, taking into account all of the facts and circumstances of a particular taxpayer's trading structure. Consistent with the best method rule, there is no priority of methods.

Application of the best method rule will depend on the structure and organization of the individual taxpayer's global dealing operation and the nature of the transaction at issue. Where a taxpayer is engaged in more than one global dealing operation, it will be necessary to segregate each activity and determine on a transaction-by-transaction basis within each activity which method provides the most reliable measure of an arm's length price. It may be appropriate to apply the same method to multiple transactions of the same type within a single business ac-

tivity entered into as part of a global dealing operation. For example, if a taxpayer operates its global dealing activity in notional principal contracts differently than its foreign exchange trading activity, then the income from notional principal contracts may be allocated using a different methodology than the income from foreign exchange trading. Moreover, the best method rule may require that different methods be used to determine whether different controlled transactions are priced at arm's length even within the same product line. For example, one method may be the most appropriate to determine if a controlled transaction between a global dealing operation and another business activity is at arm's length, while a different method may be the most appropriate to determine if the allocation of income and expenses among participants in a global dealing operation is at arm's length.

Section 1.482-8(a)(3) reiterates that the principle of comparability in §1.482-1(d) applies to transactions entered into by a global dealing operation. The comparability factors provided in §1.482-8(a)(3) (functional analysis, risk, and economic conditions), however, must be applied in place of the comparability factors discussed in §1.482-1(d)(3). The comparability factors for contractual terms in §1.482-8(a)(3) supplement the comparability factors for contractual terms in §1.482-1(d)(3)(ii). The comparability factors in this section have been included to provide guidance on the factors that may be most relevant in assessing comparability in the context of a global dealing operation.

E. Arm's Length Range

In determining the arm's length range, §1.482-1(e) will apply except as modified by these proposed regulations. In determining the reliability of an arm's length range, the IRS believes that it is necessary to consider the fact that the market for financial products is highly volatile and participants in a global dealing operation frequently earn only thin profit margins. The reliability of using a statistical range in establishing a comparable price of a financial product in a global dealing operation is based on facts and circumstances. In a global dealing operation, close proximity in time between a controlled transaction and an un-

controlled transaction may be a relevant factor in determining the reliability of the uncontrolled transaction as a measure of the arm's length price. The relevant time period will depend on the price volatility of the particular product.

The district director may, notwithstanding §1.482-1(e)(1), adjust a taxpayer's results under a method applied on a transaction-by-transaction basis if a valid statistical analysis demonstrates that the taxpayer's controlled prices, when analyzed on an aggregate basis, provide results that are not arm's length. See §1.482-1(f)(2)(iv). This may occur, for example, when there is a pattern of prices in controlled transactions that are higher or lower than the prices of comparable uncontrolled transactions.

Comments are solicited on the types of analyses and factors that may be relevant for pricing controlled financial transactions in a global dealing operation. Section 1.482-1(e) continues to apply in its entirety to transactions among participants that are common to businesses other than a global dealing operation. In this regard, the existing rules continue to apply to pricing of certain services from a participant to a regular dealer in securities other than services that give rise to participant status.

F. Comparable Uncontrolled Financial Transaction Method

The comparable uncontrolled financial transaction (CUFT) method is set forth in §1.482-8(b). The CUFT method evaluates whether controlled transactions satisfy the arm's length standard by comparing the price of a controlled financial transaction with the price of a comparable uncontrolled financial transaction. Similarity in the contractual terms and risks assumed in entering into the financial transaction are the most important comparability factors under this method.

Ordinarily, in global dealing operations, proprietary pricing models are used to calculate a financial product's price based upon market data, such as interest rates, currency rates, and market risks. The regulations contemplate that indirect evidence of the price of a CUFT may be derived from a proprietary pricing model if the data used in the model is widely and routinely used in the ordinary course of the taxpayer's business to price uncontrolled transactions, and adjustments are

made to the amount charged to reflect differences in the factors that affect the price to which uncontrolled taxpayers would agree. In addition, the proprietary pricing model must be used in the same manner to price transactions with controlled and uncontrolled parties. If a taxpayer uses its internal pricing model as evidence of a CUFT, it must, upon request, furnish the pricing model to the district director in order to substantiate its use.

G. Gross Margin Method

The gross margin method is set forth in §1.482-8(c) and should be considered in situations where a taxpayer performs only a routine marketing or sales function as part of a global dealing operation. Frequently, taxpayers that perform the sales function in these circumstances participate in the dealing of a variety of, rather than solely identical, financial products. In such a case, the variety of financial products sold within a relevant time period may limit the availability of comparable uncontrolled financial transactions. Where the taxpayer has performed a similar function for a variety of products, however, the gross margin method can be used to determine if controlled transactions are priced at arm's length by reference to the amount earned by the taxpayer for performing similar functions with respect to uncontrolled transactions.

The gross margin method determines if the gross profit realized on sales of financial products acquired from controlled parties is at arm's length by comparing that profit to the gross profit earned on uncontrolled transactions. Since comparability under this method depends on the similarity of functions performed and risks assumed, adjustments must be made for differences between the functions performed in the disposition of financial products acquired in controlled transactions and the functions performed in the disposition of financial products acquired in uncontrolled transactions. Although close product similarity will tend to improve the reliability of the gross margin method, the reliability of this method is not as dependent on product similarity as the CUFT method.

Participants in a global dealing operation may act simply as brokers, or they may participate in structuring complex products. As the role of the participant

exceeds the brokerage function, it becomes more difficult to find comparable functions because the contributions made in structuring one complex financial product are not likely to be comparable to the contributions made in structuring a different complex financial product. Accordingly, the regulations provide that the reliability of this method is decreased where a participant is substantially involved in developing a financial product or in tailoring the product to the unique requirements of a customer prior to resale.

H. Gross Markup Method

Like the gross margin method, the gross markup method set forth in §1.482-8(d) should generally be considered in situations where a taxpayer performs only a routine marketing or sales function as part of a global dealing operation, and, as is often the case, handles a variety of financial products within a relevant time period. The gross markup method is generally appropriate in cases where the taxpayer performs a routine sales function in buying a financial product from an uncontrolled party and reselling or transferring the product to a controlled party.

The gross markup method determines if the gross profit earned on the purchase of financial products from uncontrolled parties and sold to controlled taxpayers is at arm's length by comparing that profit to the gross profit earned on uncontrolled transactions. Like the gross margin method, comparability under this method depends on the similarity of the functions performed and risks assumed in the controlled and uncontrolled transactions. Accordingly, adjustments should be made for differences between the functions performed in the sale or transfer of financial products to controlled parties, and the functions performed with respect to the sale or transfer of financial products to uncontrolled parties. Although close product similarity will tend to improve the reliability of the gross markup method, the reliability of this method is not as dependent on product similarity as the CUFT method.

As in the gross margin method, the regulations provide that the reliability of this method generally is decreased where a participant is substantially involved in developing a financial product or in tailoring the product to the unique requirements of a customer prior to resale.

I. Profit Split Methods

New profit split methods are proposed for global dealing participants under §1.482-8(e). Global dealing by its nature involves a certain degree of integration among the participants in the global dealing operation. The structure of some global dealing operations may make it difficult to apply a traditional transactional method to determine if income is allocated among participants on an arm's length basis. Two profit split methods, the total profit split method and the residual profit split method, have been included as specified methods for determining if global dealing income is allocated at arm's length.

Profit split methods may be used to evaluate if the allocation of operating profit from a global dealing operation compensates the participants at arm's length for their contribution by evaluating if the allocation is one which uncontrolled parties would agree to. Accordingly, the reliability of this method is dependent upon clear identification of the respective contributions of each participant to the global dealing operation.

In general, the profit split methods must be based on objective market benchmarks that provide a high degree of reliability, i.e., comparable arrangements between unrelated parties that allocate profits in the same manner and on the same basis. Even if such comparable uncontrolled transactions are not available, however, the taxpayer may be able to demonstrate that a total profit split provides arm's length results that reflect the economic value of the contribution of each participant, by reference to other objective factors that provide reliability due to their arm's length nature. For example, an allocation of income based on trader bonuses may be reliable, under the particular facts and circumstances of a given case, if the taxpayer can demonstrate that such bonuses are based on the value added by the individual traders. By contrast, an allocation based on headcount or gross expenses may be unreliable, because the respective participants might, for example, have large differences in efficiency or cost control practices, which would tend to make such factors poor reflections of the economic value of the functions contributed by each participant.

The proposed regulations define gross profit as gross income earned by the global dealing operation. Operating expenses are those not applicable to the determination of gross income earned by the global dealing operation. The operating expenses are global expenses of the global dealing operation and are subtracted from gross profit to determine the operating profit. Taxpayers may need to allocate operating expenses that relate to more than one global dealing activity.

The regulations state that in appropriate circumstances a multi-factor formula may be used to determine whether an allocation is at arm's length. Use of a multi-factor formula is permitted so long as the formula allocates the operating profit or loss based upon the factors that uncontrolled taxpayers would consider. The regulations do not prescribe specific factors to be used in the formula since the appropriateness of any one factor will depend on all the facts and circumstances associated with the global dealing operation. However, the regulations require that the multi-factor formula take into account all of the functions performed and risks assumed by a participant, and attribute the appropriate amount of income or loss to each function. The IRS also solicits comments concerning which factors may be appropriate (for example, initial net present value of derivatives contracts) and the circumstances under which specific factors may be appropriately applied.

The purpose of the factors is to measure the relative value contributed by each participant. Thus, adjustments must be made for any circumstances other than the relative value contributed by a participant that influence the amount of a factor so that the factor does not allocate income to a participant based on circumstances that are not relevant to the value of the function or activity being measured. For example, if trader compensation is used to allocate income among participants, and the traders in two different jurisdictions would be paid different amounts (for example, due to cost of living differences) to contribute the same value, adjustments should be made for the difference so that the factors accurately measure the value contributed by the trading function. The IRS solicits comments regarding the types of adjustments that should be made, how to make such adjustments, and the need for further guidance on this point.

The total profit split method entails a one step process whereby the operating profit is allocated among the participants based on their relative contributions to the profitability of the global dealing operation. No distinction is made between routine and nonroutine contributions. The total profit split method may be useful to allocate income earned by a highly integrated global dealing operation where all routine and nonroutine dealer functions are performed by each participant in each location. Accordingly, total profit or loss of the global dealing operation may be allocated among various jurisdictions based on the relative performance of equivalent functions in each jurisdiction.

The residual profit split method entails a two step process. In the first step, the routine functions are compensated with a market return based upon the best transfer pricing method applicable to that transaction. Routine functions may include, but are not limited to, functions that would not give rise to participant status and which should be evaluated under §§1.482-3 through 1.482-6. After compensating the routine functions, the remaining operating profit (the "residual profit") is allocated among the participants based upon their respective nonroutine contributions.

It should be noted that, while in appropriate cases a profit split method may be used to determine if a participant is compensated at arm's length, use of the profit split method does not change the contractual relationship between participants, nor does it affect the character of intercompany payments. For example, if a controlled taxpayer provides solely trading services to a global dealing operation in a particular jurisdiction, any payment it receives as compensation for services retains its character as payment for services and, under the regulations, is not converted into a pro rata share of each item of gross income earned by the global dealing operation.

J. Unspecified Methods

Consistent with the principles underlying the best method rule, the regulations provide the option to use an unspecified method if it is determined to be the best method. The IRS solicits comments on the extent to which the variety of methods on which specific guidance has been provided is adequate.

Guidance on the use of a comparable profits method has specifically not been included as a specified method in the proposed regulations because use of that method depends on the existence of arrangements between uncontrolled taxpayers that perform comparable functions and assume comparable risks. Global dealing frequently involves the use of unique intangibles such as trader know-how. Additionally, anticipated profit is often influenced by the amount of risk a participant is willing to bear. Accordingly, the IRS believes it is unlikely that the comparability of these important functions can be measured and adjusted for accurately in a global dealing operation.

K. Source of Global Dealing Income

Under current final regulations in §1.863-7(a), all of the income attributable to a notional principal contract is sourced by reference to the taxpayer's residence. Exceptions are provided for effectively connected notional principal contract income, and for income earned by a foreign QBU of a U.S. resident taxpayer if the notional principal contract is properly reflected on the books of the foreign QBU. Attribution of all of the income from a notional principal contract to a single location has generally been referred to as the "all or nothing" rule. The current final regulations do not provide for multi-location sourcing of notional principal contract income among the QBUs that have participated in the acquisition or risk management of a notional principal contract and therefore do not recognize that significant activities, including structuring or risk managing derivatives, often occur through QBUs in more than one jurisdiction.

Recognizing the need for multi-location sourcing of income earned in a global dealing operation, the proposed regulations provide a new rule under §1.863-3 which sources income from a global dealing operation in the same manner as the income would be allocated under §1.482-8 if each QBU were a separate entity. However, the rules must be applied differently to take into account the economic differences between acting through a single legal entity and through separate legal entities.

Accordingly, income from a single transaction may be split-sourced to more than one location, so long as the alloca-

tion methodology satisfies the arm's length standard. The all or nothing rule of §1.863-7(a) continues to apply to notional principal contract income attributable to activities not related to a global dealing operation. Corresponding changes have been made in proposed §1.988-4(h) to exclude exchange gain or loss derived in the conduct of a global dealing operation from the general source rules in §1.988-4(b) and (c).

These special source rules apply only with respect to participants that perform a dealing, marketing, sales, pricing, risk management or brokering function. Moreover, these rules do not apply to income, such as fees for services, for which a specific source rule is provided in section 861, 862 or 865 of the Code. Accordingly, if a controlled taxpayer provides back office services, the amount and source of an intercompany payment for such services is determined under existing transfer pricing and sourcing rules applicable to those services without regard to whether the controlled taxpayer is also a participant in a global dealing operation.

If an entity directly bears the risk assumed by the global dealing operation, it should be compensated for that function. In providing, however, that the source (and effectively connected status) of global dealing income is determined by reference to where the dealing, marketing, sales, pricing, risk management or brokering function that gave rise to the income occurred, the regulations effectively provide that compensation for risk bearing should be sourced by reference to where the capital is employed by traders, marketers and salespeople, rather than the residence of the capital provider. This principle applies where a taxpayer directly bears risk arising from the conduct of a global dealing operation, such as when it acts as a counterparty without performing other global dealing functions. A special rule provides that the activities of a dependent agent may give rise to participant status through a deemed QBU that performs its participant functions in the same location where the dependent agent performs its participant functions. The deemed QBU may be created without regard to the books and records requirement of §1.989-1(b).

As indicated, accounting, back office, credit analysis, and general supervision

and policy control functions do not give rise to participant status in a global dealing operation but are services that should be remunerated and sourced separately under existing rules. This principle also applies where a taxpayer bears risk indirectly, such as through the extension of a guarantee. Accordingly, the sourcing rule of §1.863-3(h) does not apply to interest, dividend, or guarantee fee income received by an owner or guarantor of a global dealing operation that is conducted by another controlled taxpayer. The source of interest, dividend and guarantee fee income, substitute interest and substitute dividend payments sourced under §§1.861-2(a)(7) and 1.861-3(a)(6), and other income sourced by section 861, 862 or 865 continues to be governed by the source rules applicable to those transactions.

The proposed regulations provide, consistent with U.S. tax principles, that an agreement between two QBUs of a single taxpayer does not give rise to a transaction because a taxpayer cannot enter into nor profit from a "transaction" with itself. See, e.g., §1.446-3(c)(1). The IRS believes, however, that these agreements between QBUs of a single taxpayer may provide evidence of how income from the taxpayer's transactions with third parties should be allocated among QBUs. It is a common practice for taxpayers to allocate income or loss from transactions with third parties among QBUs for internal control and risk management purposes. Accordingly, the proposed regulations specifically provide that such allocations may be used to source income to the same extent and in the same manner as they may be used to allocate income between related persons. Conversely, such transactions may not be used to the extent they do not provide an arm's length result.

L. Determination of Global Dealing Income Effectively Connected with a U.S. Business

After determining the source of income, it is necessary to determine the extent to which such income is ECI. Under current law, the general rule is that all of the income, gain or loss from a global dealing operation is effectively connected with a U.S. trade or business if the U.S. trade or business materially participates in the acquisition of the asset that gives rise

to the income, gain or loss, or property is held for use in the active conduct of a U.S. trade or business, or the business activities conducted by the U.S. trade or business are a material factor in the realization of income, gain or loss. As noted above, the current final regulations do not permit the attribution of income, gain or loss from a global dealing operation that is allocated and sourced to a U.S. trade or business under §1.863-3(h) shall be effectively connected. In this regard, an asset used in a global dealing operation is treated as an asset used in a U.S. trade or business to the extent that an allocation is made to a U.S. QBU. Similarly, the U.S. trade or business is also treated as a material factor in the realization of income, gain or loss for which an allocation is made to a U.S. QBU. A special rule for U.S. source interest and dividend income, including substitute interest and substitute dividends, earned by a foreign banking or similar financial institution in a global dealing operation treats such income as attributable to a U.S. trade or business to the extent such income would be sourced to the United States under §1.863-3(h). Any foreign source income allocated to the United States under the principles of §1.863-3(h) is also treated as attributable to the U.S. trade or business.

The proposed regulations also limit an entity's effectively connected income from a global dealing operation to that portion of an item of income, gain or loss that would be sourced to the U.S. trade or business if the rules of §1.863-3(h) were to apply. These rules are intended to ensure that income for which a specific source rule is provided in section 861, 862 or 865 does not produce effectively connected income unless it was earned through functions performed by a U.S. QBU of the taxpayer.

With respect to notional principal contract income and foreign exchange gain or loss, proposed §§1.863-3(h) and 1.988-4(h) also provide that such income, gain or loss is effectively connected with the conduct of a U.S. trade or business to the extent that it is sourced to the United States under §1.863-3(h).

In certain circumstances, the global dealing activities of an entity acting as the agent of a foreign taxpayer in the United States may cause the foreign taxpayer to be engaged in a U.S. trade or business.

Any income effectively connected with the U.S. trade or business must be reported by the foreign corporation on a timely filed U.S. tax return in order for the foreign corporation to be eligible for deductions and credits attributable to such income. See §1.882-4. In addition, the agent must also report any income earned in its capacity as agent on its own tax return. The provisions governing the time and manner for foreign corporations to make elections under §§1.882-5 and 1.884-1 remain in force as promulgated. Under current rules, these formalities must be observed even if all of the global dealing income would be allocated between a U.S. corporation and a foreign corporation's U.S. trade or business. The IRS believes that these requirements are justified because of potential differences that might occur with respect to the realization of losses and between actual dividend remittances of a U.S. corporation and deemed dividend remittances under the branch profits tax. The IRS, however, solicits comments regarding whether these filing requirements can be simplified, taking into consideration the policies underlying the filing requirements of §1.882-4.

The Business Profits article contained in U.S. income tax treaties requires the United States to attribute to a permanent establishment that portion of the income earned by the entity from transactions with third parties that the permanent establishment might be expected to earn if it were an independent enterprise. Because the proposed regulations contained in this document allocate global trading income among permanent establishments under the arm's length principle of the Associated Enterprises article of U.S. income tax treaties, such rules are consistent with our obligations under the Business Profits article. Accordingly, a proposed rule under section 894 provides that, if a taxpayer is engaged in a global dealing operation through a U.S. permanent establishment, the proposed regulations will apply to determine the income attributable to that U.S. permanent establishment under the applicable U.S. income tax treaty.

M. Relationship to Other Regulations

The allocation rules contained herein do not apply to the allocation of interest expense. As discussed in the preamble to

§1.882-5 (T.D. 8658, 1996-1 C.B. 161, 162, 61 F.R. 9326, March 5, 1996), the rules contained in §1.882-5 are the exclusive rules for allocating interest expense, including under U.S. income tax treaties.

Proposed regulations have been issued under sections 882 and 884 (INTL-0054-95, 1996-1 C.B. 844, 61 F.R. 9377, March 5, 1996) for purposes of allocating interest expense and determining the U.S. assets and/or liabilities reflected on the books of a foreign corporation's U.S. trade or business that are attributable to its activities as a dealer under section 475. The proposed regulations (and similar final regulations) under section 884 address the treatment of assets which give rise to both effectively connected and non-effectively connected income. Those rules thus address a situation analogous to the split-sourcing situation addressed in these proposed regulations. The IRS anticipates issuing proposed regulations under section 861 that provide a similar rule for purposes of allocating interest expense of a U.S. corporation that has assets that give rise to split-sourced income. Comments are solicited on the compatibility of the proposed regulations contained in this document with the principles of the proposed regulations that address a foreign corporation's allocation of interest expense, including its computation of U.S. assets included in step 1 of the §1.882-5 formula and component liabilities included in steps 2 and 3 of the §1.882-5 formula.

The IRS believes that the transfer pricing compliance issues associated with a global dealing operation are substantially similar to those raised by related party transactions generally. The IRS also believes that the existing regulations under section 6662 adequately address these issues. Accordingly, amendments have not been proposed to the regulations under section 6662. Section 6662 may not in certain circumstances, however, apply to the computation of effectively connected income in accordance with proposed regulations under section 475, 863, 864 or 988 contained in this document. The IRS will propose regulations under section 6038C regarding the information reporting and recordkeeping requirements applicable to foreign corporations engaged in a global dealing operation. It is anticipated that these regulations will coordi-

nate the application of sections 6662 and 6038C where necessary.

No inference should be drawn from the examples in these proposed regulations concerning the treatment or significance of liquidity and creditworthiness or the effect of such items on the valuation of a security. The purpose of the proposed regulations under section 482 is not to provide guidance on the valuation of a security, but rather to determine whether the prices of controlled transactions satisfy the arm's length standard. Section 475 and the regulations thereunder continue to govern exclusively the valuation of securities.

N. Section 475

A dealer in securities as defined in section 475 is generally required to mark its securities to market. Securities are exempt from mark-to-market accounting if the securities are held for investment or not held for sale to customers and are properly identified on the taxpayer's books and records. Additionally, securities that hedge positions that are not subject to mark-to-market accounting are exempt from mark-to-market accounting if they are properly identified.

Under the current regulations, a taxpayer may not take into account an agreement between separate business units within the same entity that transfers risk management responsibility from a non-dealing business unit to a dealing business unit. Moreover, such an agreement may not be used to allocate income, expense, gain or loss between activities that are accounted for on a mark-to-market basis and activities that are accounted for on a non-mark-to-market basis. In contrast, the regulations proposed in this document under sections 482, 863, 864, 894, and 988 allow a taxpayer to take into account records of internal transfers when allocating global dealing income earned from third parties for purposes of determining source and effectively connected income. This may cause a mismatch in the timing of income, expense, gain, or loss.

For example, if a taxpayer's lending desk enters into a third-party transaction that exposes the lending desk to currency or interest rate risk, the lending desk may transfer responsibility for managing the risk for that particular transaction to another business activity that can manage

the risk more efficiently (e.g., the desk that deals in currency or interest rate derivatives). The dealing desk then, in the ordinary course of its business, may enter into a transaction such as a swap with a third party to hedge the aggregate risk of the dealing desk and, indirectly, the risk incurred by the lending desk with respect to the original transaction. Where, as is generally the case, the dealing desk has a large volume of transactions, it is not possible as a practical matter to associate the aggregate hedge with the risk of the lending desk. Since the transactions entered into by the dealing desk must generally be marked to market, the third-party transaction that hedges the aggregate risk of the dealing desk (which includes the risk transferred from the lending desk) must generally also be marked. To the extent that a portion of the income, expense, gain, or loss from the aggregate hedging transaction is allocated to the lending desk under the proposed global dealing regulations, the potential timing mismatch described above will occur if the lending desk accounts for its positions on a non-mark-to-market basis. This mismatch could occur because the portion of the income, expense, gain, or loss from the hedging transaction, although allocated to the lending desk for sourcing and effectively connected income purposes, will be accounted for on a mark-to-market basis under the dealing desk's method of accounting. Entirely exempting the aggregate hedging transaction from mark-to-market accounting does not adequately solve this problem, because it results in the portion of the income, expense, gain or loss from the aggregate hedging transaction that is allocated to the dealing desk being accounted for on other than a mark-to-market method.

As the example shows, respecting records of internal transfers for purposes of sourcing without respecting these same records for purposes of timing could produce unpredictable and arbitrary results. Accordingly, the proposed regulations permit participants in a global dealing operation to respect records of internal transfers in applying the timing rules of section 475. Because the need to reconcile sourcing and timing exists only in the context of a cross-border operation, the proposed regulations have a limited scope. In particular, for the proposed regu-

lations to apply, income of the global dealing desk must be subject to allocation among two or more jurisdictions or be sourced to two or more jurisdictions.

The purpose of the proposed regulations under section 475 is to coordinate section 475 with the proposed global dealing regulations and to facilitate identification of the amount of income, expense, gain or loss from third party transactions that is subject to mark-to-market accounting. This rule is not intended to allow a shifting of income inconsistent with the arm's length standard.

Under the proposed section 475 regulations, an interdesk agreement or "risk transfer agreement" (RTA) includes a transfer of responsibility for risk management between a business unit that is hedging some of its risk (the hedging QBU) and another business unit of the same taxpayer that uses mark-to-market accounting (the marking QBU). If the marking QBU, the hedging QBU, and the RTA satisfy certain requirements, the RTA is taken into account for purposes of determining the timing of income allocated by the proposed global dealing regulations to the separate business units of a taxpayer.

The proposed amendments to the section 475 regulations require that the marking QBU must be a dealer within the meaning of proposed §1.482-8(a)(2)(iii) and that its income must be allocated to at least two jurisdictions under proposed §1.482-8 or sourced to at least two jurisdictions under proposed §1.863-3(h). Additionally, the RTA qualifies only if the marking QBU would mark its side of the RTA to market under section 475 if the transaction were with an unrelated third party. Thus, if the marking QBU were to identify the RTA as a hedge of a position that is not subject to mark-to-market accounting (such as debt issued by the marking QBU), the RTA would not qualify. The IRS requests comments on whether the marking QBU should ever be able to exempt its position in the RTA from mark-to-market treatment and account for its position in the RTA.

The proposed amendments to the section 475 regulations are intended to address situations where the hedging QBU transfers responsibility for the management of risk arising from a transaction with a third party. Accordingly, the proposed regulations require that the hedging

QBU's position in the RTA would be a hedge within the meaning of §1.1221-2(b) if the transaction were entered into with an unrelated entity. The IRS solicits comments on whether this requirement is broad enough to address the business needs of entities engaged in global dealing and nondealing activities. Comments that suggest broadening the requirement (e.g., to include risk reduction with respect to capital assets) should address how such a regime could be coordinated with other relevant rules (e.g., the straddle rules). Additionally, if a taxpayer suggests changes to the section 475 rules proposed in this notice, the IRS requests additional comments addressing whether or not corresponding changes should be made to §1.1221-2(d).

The proposed regulations also require that the RTA be recorded on the books and records of the QBU no later than the time the RTA is effective. RTAs that are not timely recorded do not qualify under the proposed regulations. Additionally, the RTA must be accounted for in a manner that is consistent with the QBU's usual accounting practices.

If all of the requirements of the proposed regulations are satisfied, then for purposes of determining the timing of income, expense, gain, or loss allocated to a QBU under the global dealing regulations, the marking QBU and the hedging QBU account for their respective positions in the RTA as if the position were entered into with an unrelated third party.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory impact analysis is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that these regulations affect entities who participate in cross-border global dealing of stocks and securities. These regulations affect the source of income and allocation of income, deductions, credits, and allowances among such entities. The primary participants who engage in cross-border global dealing activities are large regulated commercial banks and brokerage firms, and investment banks. Accord-

ingly, the IRS does not believe that a substantial number of small entities engage in cross-border global dealing activities covered by these regulation. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. Chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely to the IRS (a signed original and eight (8) copies). All comments will be available for public inspection and copying.

A public hearing has been scheduled for July 9, 1998, at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by June 4, 1998, and submit an outline of the topics to be discussed and the time to be devoted to each topic by June 18, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Proposed Effective Date

These regulations are proposed to be effective for taxable years beginning after the date final regulations are published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Ginny Chung of the Office of Associate Chief Counsel (International) and Richard Hoge of the Office of Assistant Chief Counsel (Financial Institutions

& Products). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

Part 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

§1.475(g)–2 also issued under 26 U.S.C. 475. * * *

§1.482–8 also issued under 26 U.S.C. 482. * * *

Section 1.863–3(h) also issued under 26 U.S.C. 863 and 26 U.S.C. 865(j). * * *

Section 1.988–4(h) also issued under 26 U.S.C. 863 and 26 U.S.C. 988. * * *

Par. 2. Section 1.475(g)–2 is added as follows:

§1.475(g)–2 Risk transfer agreements in a global dealing operation.

(a) *In general.* This section provides computational rules to coordinate the application of section 475 and §1.446–4 with rules for allocation and sourcing under the global dealing regulations. If the requirements in paragraph (c) of this section are met, a risk transfer agreement (RTA) (as defined in paragraph (b) of this section) is accounted for under the rules of paragraph (d) of this section.

(b) *Definition of risk transfer agreement.* For purposes of this section, a risk transfer agreement (RTA) is a transfer of risk between two qualified business units (QBUs) (as defined in §1.989(a)–1(b)) of the same taxpayer such that—

(1) The transfer is consistent with the business practices and risk management policies of each QBU;

(2) The transfer is evidenced in each QBU's books and records;

(3) Each QBU records the RTA on its books and records at a time no later than the time the RTA is effective; and

(4) Except to the extent required by paragraph (b)(3) of this section, the entry in the books and records of each QBU is consistent with that QBU's normal accounting practices.

(c) *Requirements for application of operational rule*—(1) The position in the RTA of one QBU (the hedging QBU) would qualify as a hedging transaction (within the meaning of §1.1221–2(b)) with respect to that QBU if—

(i) The RTA were a transaction entered into with an unrelated party; and

(ii) For purposes of determining whether the hedging QBU's position satisfies the risk reduction requirement in §1.1221–2(b), the only risks taken into account are the risks of the hedging QBU (that is, the risks that would be taken into account if the hedging QBU were a separate corporation that had made a separate-entity election under §1.1221–2(d)(2));

(2) The other QBU (the marking QBU) is a regular dealer in securities (within the meaning of §1.482–8(a)(2)(iii));

(3) The marking QBU would mark to market its position in the RTA under section 475 if the RTA were a transaction entered into with an unrelated party; and

(4) Income of the marking QBU is subject to allocation under §1.482–8 to two or more jurisdictions or is sourced under §1.863–3(h) to two or more jurisdictions.

(d) *Operational rule.* If the requirements in paragraph (c) of this section are met, each QBU that is a party to a RTA (as defined in paragraph (b) of this section) takes its position in the RTA into account as if that QBU had entered into the RTA with an unrelated party. Thus, the marking QBU marks its position to market, and the hedging QBU accounts for its position under §1.446–4. Because this section only effects coordination with the allocation and sourcing rules, it does not affect factors such as the determination of the amount of interest expense that is incurred by either QBU and that is subject to allocation and apportionment under section 864(e) or 882(c).

Par. 3. Section 1.482–0 is amended as follows:

1. The introductory text is revised.

2. The section heading and entries for §1.482–8 are redesignated as the section heading and entries for §1.482–9.

3. A new section heading and entries for §1.482–8 are added.

The addition and revision read as follows:

§1.482–0 Outline of regulations under section 482.

This section contains major captions for §§1.482–1 through 1.482–9.

* * * * *

§1.482–8 Allocation of income earned in a global dealing operation.

- (a) General requirements and definitions.
 - (1) In general.
 - (2) Definitions.
 - (i) Global dealing operation.
 - (ii) Participant.
 - (iii) Regular dealer in securities.
 - (iv) Security.
 - (3) Factors for determining comparability for a global dealing operation.
 - (i) Functional analysis.
 - (ii) Contractual terms.
 - (iii) Risk.
 - (iv) Economic conditions.
 - (4) Arm's length range.
 - (i) General rule.
 - (ii) Reliability.
 - (iii) Authority to make adjustments.
 - (5) Examples.
- (b) Comparable uncontrolled financial transaction method.
 - (1) General rule.
 - (2) Comparability and reliability.
 - (i) In general.
 - (ii) Adjustments for differences between controlled and uncontrolled transactions.
 - (iii) Data and assumptions.
 - (3) Indirect evidence of the price of a comparable uncontrolled financial transaction.
 - (i) In general.
 - (ii) Public exchanges or quotation media.
 - (iii) Limitation on use of public exchanges or quotation media.
 - (4) Arm's length range.
 - (5) Examples.
 - (c) Gross margin method.
 - (1) General rule.
 - (2) Determination of an arm's length price.
 - (i) In general.
 - (ii) Applicable resale price.
 - (iii) Appropriate gross profit.
 - (3) Comparability.
 - (i) In general.
 - (ii) Adjustments for differences between controlled and uncontrolled transactions.
 - (iii) Reliability.
 - (iv) Data and assumptions.
 - (A) In general.
 - (B) Consistency in accounting.

- (4) Arm's length range.
- (5) Example.
- (d) Gross markup method.
 - (1) General rule.
 - (2) Determination of an arm's length price.
 - (i) In general.
 - (ii) Appropriate gross profit.
 - (3) Comparability and reliability.
 - (i) In general.
 - (ii) Adjustments for differences between controlled and uncontrolled transactions.
 - (iii) Reliability.
 - (iv) Data and assumptions.
 - (A) In general.
 - (B) Consistency in accounting.
 - (4) Arm's length range.
 - (e) Profit split method.
 - (1) General rule.
 - (2) Appropriate share of profit and loss.
 - (i) In general.
 - (ii) Adjustment of factors to measure contribution clearly.
 - (3) Definitions.
 - (4) Application.
 - (5) Total profit split.
 - (i) In general.
 - (ii) Comparability.
 - (iii) Reliability.
 - (iv) Data and assumptions.
 - (A) In general.
 - (B) Consistency in accounting.
 - (6) Residual profit split.
 - (i) In general.
 - (ii) Allocate income to routine contributions.
 - (iii) Allocate residual profit.
 - (iv) Comparability.
 - (v) Reliability.
 - (vi) Data and assumptions.
 - (A) General rule.
 - (B) Consistency in accounting.
 - (7) Arm's length range.
 - (8) Examples.
 - (f) Unspecified methods.
 - (g) Source rule for qualified business units.

Par. 4. Section 1.482–1 is amended as follows:

- 1. In paragraph (a)(1), remove the last sentence and add two new sentences in its place.
- 2. Revise paragraph (b)(2)(i).
- 3. In paragraph (c)(1), revise the last sentence.
- 4. In paragraph (d)(3)(v), revise the last sentence.

5. In paragraph (i), revise the introductory text.

The additions and revisions read as follows:

§1.482–1 Allocation of income and deductions among taxpayers.

(a) *In general*—(1) *Purpose and scope.* * * * Section 1.482–8 elaborates on the rules that apply to controlled entities engaged in a global securities dealing operation. Finally, §1.482–9 provides examples illustrating the application of the best method rule.

* * * * *

(b) * * *

(2) * * *

(i) *Methods.* Sections 1.482–2 through 1.482–6 and §1.482–8 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result.

(c) *Best method rule*—(1) *In general.* * * * See §1.482–9 for examples of the application of the best method rule.

* * * * *

(d) * * *

(3) * * *

(v) *Property or services.* * * * For guidance concerning the specific comparability considerations applicable to transfers of tangible and intangible property, see §§1.482–3 through 1.482–6 and §1.482–8; see also §1.482–3(f), dealing with the coordination of the intangible and tangible property rules.

* * * * *

(i) *Definitions.* The definitions set forth in paragraphs (i)(1) through (10) of this section apply to §§1.482–1 through 1.482–9.

* * * * *

Par. 5. Section 1.482–2 is amended as follows:

1. In paragraph (a)(3)(iv), revise the first sentence.

2. Revise paragraph (d).

The revisions read as follows:

§1.482–2 Determination of taxable income in specific situations.

(a) * * *

(3) * * *

(iv) Fourth, section 482 and paragraphs (b) through (d) of this section and §§1.482-3 through 1.482-8, if applicable, may be applied by the district director to make any appropriate allocations, other than an interest rate adjustment, to reflect an arm's length transaction based upon the principal amount of the loan or advance and the interest rate as adjusted under paragraph (a)(3)(i), (ii), or (iii) of this section. * * *

* * * * *

(d) *Transfer of property.* For rules governing allocations under section 482 to reflect an arm's length consideration for controlled transactions involving the transfer of property, see §§1.482-3 through 1.482-6 and §1.482-8.

§1.482-8 [Redesignated as §1.482-9]

Par. 6. Section 1.482-8 is redesignated as §1.482-9 and a new §1.482-8 is added to read as follows:

§1.482-8 Allocation of income earned in a global securities dealing operation.

(a) *General requirements and definitions*—(1) *In general.* Where two or more controlled taxpayers are participants in a global dealing operation, the allocation of income, gains, losses, deductions, credits and allowances (referred to herein as income and deductions) from the global dealing operation is determined under this section. The arm's length allocation of income and deductions related to a global dealing operation must be determined under one of the methods listed in paragraphs (b) through (f) of this section. Each of the methods must be applied in accordance with all of the provisions of §1.482-1, including the best method rule of §1.482-1(c), the comparability analysis of §1.482-1(d), and the arm's length range of §1.482-1(e), as those sections are supplemented or modified in paragraphs (a)(3) and (a)(4) of this section. The available methods are—

(i) The comparable uncontrolled financial transaction method, described in paragraph (b) of this section;

(ii) The gross margin method, described in paragraph (c) of this section;

(iii) The gross markup method, described in paragraph (d) of this section;

(iv) The profit split method, described in paragraph (e) of this section; and

(v) Unspecified methods, described in paragraph (f) of this section.

(2) *Definitions*—(i) *Global dealing operation.* A global dealing operation consists of the execution of customer transactions, including marketing, sales, pricing and risk management activities, in a particular financial product or line of financial products, in multiple tax jurisdictions and/or through multiple participants, as defined in paragraph (a)(2)(ii) of this section. The taking of proprietary positions is not included within the definition of a global dealing operation unless the proprietary positions are entered into by a regular dealer in securities in its capacity as such a dealer under paragraph (a)(2)(iii) of this section. Lending activities are not included within the definition of a global dealing operation. Therefore, income earned from such lending activities or from securities held for investment is not income from a global dealing operation and is not governed by this section. A global dealing operation may consist of several different business activities engaged in by participants. Whether a separate business activity is a global dealing operation shall be determined with respect to each type of financial product entered on the taxpayer's books and records.

(ii) *Participant*—(A) A participant is a controlled taxpayer, as defined in §1.482-1(i)(5), that is—

(I) A regular dealer in securities as defined in paragraph (a)(2)(iii) of this section; or

(2) A member of a group of controlled taxpayers which includes a regular dealer in securities, but only if that member conducts one or more activities related to the activities of such dealer.

(B) For purposes of paragraph (a)(2)(ii)(A)(2) of this section, such related activities are marketing, sales, pricing, risk management or brokering activities. Such related activities do not include credit analysis, accounting services, back office services, general supervision and control over the policies of the controlled taxpayer, or the provision of a guarantee of one or more transactions entered into by a regular dealer in securities or other participant.

(iii) *Regular dealer in securities.* For purposes of this section, a regular dealer in securities is a taxpayer that—

(A) Regularly and actively offers to, and in fact does, purchase securities from and sell securities to customers who are not controlled taxpayers in the ordinary course of a trade or business; or

(B) Regularly and actively offers to, and in fact does, enter into, assume, offset, assign or otherwise terminate positions in securities with customers who are not controlled entities in the ordinary course of a trade or business.

(iv) *Security.* For purposes of this section, a security is a security as defined in section 475(c)(2) or foreign currency.

(3) *Factors for determining comparability for a global dealing operation.* The comparability factors set out in this paragraph (a)(3) must be applied in place of the comparability factors described in §1.482-1(d)(3) for purposes of evaluating a global dealing operation.

(i) *Functional analysis.* In lieu of the list set forth in §1.482-1(d)(3)(i)(A) through (H), functions that may need to be accounted for in determining the comparability of two transactions are—

- (A) Product research and development;
- (B) Marketing;
- (C) Pricing;
- (D) Brokering; and
- (E) Risk management.

(ii) *Contractual terms.* In addition to the terms set forth in §1.482-1(d)(3)(ii)(A), and subject to §1.482-1(d)(3)(ii)(B), significant contractual terms for financial products transactions include—

- (A) Sales or purchase volume;
- (B) Rights to modify or transfer the contract;
- (C) Contingencies to which the contract is subject or that are embedded in the contract;
- (D) Length of the contract;
- (E) Settlement date;
- (F) Place of settlement (or delivery);
- (G) Notional principal amount;
- (H) Specified indices;
- (I) The currency or currencies in which the contract is denominated;

(J) Choice of law and jurisdiction governing the contract to the extent chosen by the parties; and

(K) Dispute resolution, including binding arbitration.

(iii) *Risk.* In lieu of the list set forth in §1.482-1(d)(3), significant risks that could affect the prices or profitability include—

(A) Market risks, including the volatility of the price of the underlying property;

(B) Liquidity risks, including the fact that the property (or the hedges of the property) trades in a thinly traded market;

(C) Hedging risks;

(D) Creditworthiness of the counterparty; and

(E) Country and transfer risk.

(iv) *Economic conditions.* In lieu of the list set forth in §1.482-1(d)(3)(iv)(A) through (H), significant economic conditions that could affect the prices or profitability include—

(A) The similarity of geographic markets;

(B) The relative size and sophistication of the markets;

(C) The alternatives reasonably available to the buyer and seller;

(D) The volatility of the market; and

(E) The time the particular transaction is entered into.

(4) *Arm's length range*— (i) *General rule.* Except as modified in this paragraph (a)(4), §1.482-1(e) will apply to determine the arm's length range of transactions entered into by a global dealing operation as defined in paragraph (a)(2)(i) of this section. In determining the arm's length range, whether the participant is a buyer or seller is a relevant factor.

(ii) *Reliability.* In determining the reliability of an arm's length range, it is necessary to consider the fact that the market for financial products is highly volatile and participants in a global dealing operation frequently earn only thin profit margins. The reliability of using a statistical range in establishing a comparable price of a financial product in a global dealing operation is based on facts and circumstances. In a global dealing operation, close proximity in time between a controlled transaction and an uncontrolled transaction may be a relevant factor in determining the reliability of the uncontrolled transaction as a measure of the arm's length price. The relevant time period will depend on the price volatility of the particular product.

(iii) *Authority to make adjustments.* The district director may, notwithstanding §1.482-1(e)(1), adjust a taxpayer's results under a method applied on a transaction by transaction basis if a valid statistical analysis demonstrates that the taxpayer's controlled prices, when analyzed on an

aggregate basis, provide results that are not arm's length. See §1.482-1(f)(2)(iv). This may occur, for example, when there is a pattern of prices in controlled transactions that are higher or lower than the prices of comparable uncontrolled transactions.

(5) *Examples.* The following examples illustrate the principles of this paragraph (a).

Example 1. Identification of participants. (i) B is a foreign bank that acts as a market maker in foreign currency in country X, the country of which it is a resident. C, a country Y resident corporation, D, a country Z resident corporation, and USFX, a U.S. resident corporation are all members of a controlled group of taxpayers with B, and each acts as a market maker in foreign currency. In addition to market-making activities conducted in their respective countries, C, D, and USFX each employ marketers and traders, who also perform risk management with respect to their foreign currency operations. In a typical business day, B, C, D, and USFX each enter into several hundred spot and forward contracts to purchase and sell Deutsche marks (DM) with unrelated third parties on the interbank market. In the ordinary course of business, B, C, D, and USFX also enter into contracts to purchase and sell DM with each other.

(ii) Under §1.482-8(a)(2)(iii), B, C, D, and USFX are each regular dealers in securities because they each regularly and actively offer to, and in fact do, purchase and sell currencies to customers who are not controlled taxpayers, in the ordinary course of their trade or business. Consequently, each controlled taxpayer is also a participant. Together, B, C, D, and USFX conduct a global dealing operation within the meaning of §1.482-8(a)(2)(i) because they execute customer transactions in multiple tax jurisdictions. Accordingly, the controlled transactions between B, C, D, and USFX are evaluated under the rules of §1.482-8.

Example 2. Identification of participants. (i) The facts are the same as in Example 1, except that USFX is the only member of the group of controlled taxpayers that buys from and sells foreign currency to customers. C performs marketing and pricing activities with respect to the controlled group's foreign currency operation. D performs accounting and back office services for B, C, and USFX, but does not perform any marketing, sales, pricing, risk management or brokering activities with respect to the controlled group's foreign currency operation. B provides guarantees for all transactions entered into by USFX.

(ii) Under §1.482-8(a)(2)(iii), USFX is a regular dealer in securities and therefore is a participant. C also is a participant because it performs activities related to USFX's foreign currency dealing activities. USFX's and C's controlled transactions relating to their DM activities are evaluated under §1.482-8. D is not a participant in a global dealing operation because its accounting and back office services are not related activities within the meaning of §1.482-8(a)(2)(ii)(B). B also is not a participant in a global dealing operation because its guarantee function is not a related activity within the meaning of §1.482-

8(a)(2)(ii)(B). Accordingly, the determination of whether transactions between B and D and other members of the controlled group are at arm's length is not determined under §1.482-8.

Example 3. Scope of a global dealing operation.

(i) C, a U.S. resident commercial bank, conducts a banking business in the United States and in countries X and Y through foreign branches. C regularly and actively offers to, and in fact does, purchase from and sell foreign currency to customers who are not controlled taxpayers in the ordinary course of its trade or business in the United States and countries X and Y. In all the same jurisdictions, C also regularly and actively offers to, and in fact does, enter into, assume, offset, assign, or otherwise terminate positions in interest rate and cross-currency swaps with customers who are not controlled taxpayers. In addition, C regularly makes loans to customers through its U.S. and foreign branches. C regularly sells these loans to a financial institution that repackages the loans into securities.

(ii) C is a regular dealer in securities within the meaning of §1.482-8(a)(2)(ii) because it purchases and sells foreign currency and enters into interest rate and cross-currency swaps with customers. Because C conducts these activities through U.S. and foreign branches, these activities constitute a global dealing operation within the meaning of §1.482-8(a)(2)(i). The income, expense, gain or loss from C's global dealing operation is sourced under §§1.863-3(h) and 1.988-4(h). Under §1.482-8(a)(2)(i), C's lending activities are not, however, part of a global dealing operation.

Example 4. Dissimilar products. The facts are the same as in Example 1, but B, C, D, and USFX also act as a market maker in Malaysian ringgit-U.S. dollar cross-currency options in the United States and countries X, Y, and Z. The ringgit is not widely traded throughout the world and is considered a thinly traded currency. The functional analysis required by §1.482-8(a)(3)(i) shows that the development, marketing, pricing, and risk management of ringgit-U.S. dollar cross-currency option contracts are different than that of other foreign currency contracts, including option contracts. Moreover, the contractual terms, risks, and economic conditions of ringgit-U.S. dollar cross-currency option contracts differ considerably from that of other foreign currency contracts, including option contracts. See §1.482-8(a)(3)(ii) through (iv). Accordingly, the ringgit-U.S. dollar cross-currency option contracts are not comparable to contracts in other foreign currencies.

Example 5. Relevant time period. (i) USFX is a U.S. resident corporation that is a regular dealer in securities acting as a market maker in foreign currency by buying from and selling currencies to customers. C performs marketing and pricing activities with respect to USFX's foreign currency operation. Trading in Deutsche marks (DM) is conducted between 10:00 a.m. and 10:30 a.m. and between 10:45 a.m. and 11:00 a.m. under the following circumstances.

10:00 a.m.	1.827DM: \$1	Uncontrolled Transaction
10:04 a.m.	1.827DM: \$1	Controlled Transaction
10:06 a.m.	1.826DM: \$1	Uncontrolled Transaction
10:08 a.m.	1.825DM: \$1	Uncontrolled Transaction
10:10 a.m.	1.827DM: \$1	Controlled Transaction
10:12 a.m.	1.824DM: \$1	Uncontrolled Transaction
10:15 a.m.	1.825DM: \$1	Uncontrolled Transaction

10:18 a.m. 1.826DM: \$1 Controlled Transaction
 10:20 a.m. 1.824DM: \$1 Uncontrolled Transaction
 10:23 a.m. 1.825DM: \$1 Uncontrolled Transaction
 10:25 a.m. 1.825DM: \$1 Uncontrolled Transaction
 10:27 a.m. 1.827DM: \$1 Controlled Transaction
 10:30 a.m. 1.824DM: \$1 Uncontrolled Transaction
 10:45 a.m. 1.822DM: \$1 Uncontrolled Transaction
 10:50 a.m. 1.821DM: \$1 Uncontrolled Transaction
 10:55 a.m. 1.822DM: \$1 Uncontrolled Transaction
 11:00 a.m. 1.819DM: \$1 Uncontrolled Transaction

(ii) USFX and C are participants in a global dealing operation under §1.482–8(a)(2)(i). Therefore, USFX determines its arm's length price for its controlled DM contracts under §1.482–8(a)(4). Under §1.482–8(a)(4), the relevant arm's length range for setting the prices of USFX's controlled DM transactions occurs between 10:00 a.m. and 10:30 a.m. Because USFX has no controlled transactions between 10:45 a.m. and 11:00 a.m., and the price movement during this later time period continued to decrease, the 10:45 a.m. to 11:00 a.m. time period is not part of the relevant arm's length range for pricing USFX's controlled transactions.

(b) *Comparable uncontrolled financial transaction method*—(1) *General rule.* The comparable uncontrolled financial transaction (CUFT) method evaluates whether the amount charged in a controlled financial transaction is arm's length by reference to the amount charged in a comparable uncontrolled financial transaction.

(2) *Comparability and reliability*—(i) *In general.* The provisions of §1.482–1(d), as modified by paragraph (a)(3) of this section, apply in determining whether a controlled financial transaction is comparable to a particular uncontrolled financial transaction. All of the relevant factors in paragraph (a)(3) of this section must be considered in determining the comparability of the two financial transactions. Comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. Accordingly, unless the controlled taxpayer can demonstrate that the relevant aspects of the controlled and uncontrolled financial transactions are comparable, the reliability of the results as a measure of an arm's length price is substantially reduced.

(ii) *Adjustments for differences between controlled and uncontrolled transactions.* If there are differences between controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of §1.482–1(d)(2) and paragraph (a)(3) of this section.

(iii) *Data and assumptions.* The reliability of the results derived from the CUFT method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See §1.482–1(c)(2)(ii). In the case of a global dealing operation in which the CUFT is set through the use of indirect evidence, participants generally must establish data from a public exchange or quotation media contemporaneously to the time of the transaction, retain records of such data, and upon request furnish to the district director any pricing model used to establish indirect evidence of a CUFT, in order for this method to be a reliable means of evaluating the arm's length nature of the controlled transactions.

(3) *Indirect evidence of the price of a comparable uncontrolled financial transaction*—(i) *In general.* The price of a CUFT may be derived from data from public exchanges or quotation media if the following requirements are met—

(A) The data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;

(B) The data derived from public exchanges or quotation media is used to set prices in the controlled transaction in the same way it is used for uncontrolled transactions of the taxpayer, or the same way it is used by uncontrolled taxpayers; and

(C) The amount charged in the controlled transaction is adjusted to reflect differences in quantity, contractual terms, counterparties, and other factors that affect the price to which uncontrolled taxpayers would agree.

(ii) *Public exchanges or quotation media.* For purposes of paragraph (b)(3)(i) of this section, an established financial market, as defined in §1.1092(d)–1(b), qualifies as a public exchange or a quotation media.

(iii) *Limitation on use of data from public exchanges or quotation media.* Use of data from public exchanges or quotation media is not appropriate under extraordinary market conditions. For example, under circumstances where the trading or transfer of a particular country's currency has been suspended or blocked by another country, causing significant instability in the prices of foreign

currency contracts in the suspended or blocked currency, the prices listed on a quotation medium may not reflect a reliable measure of an arm's length result.

(4) *Arm's length range.* See §1.482–1(e)(2) and paragraph (a)(4) of this section for the determination of an arm's length range.

(5) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1. Comparable uncontrolled financial transactions. (i) B is a foreign bank resident in country X that acts as a market maker in foreign currency in country X. C, a country Y resident corporation, D, a country Z resident corporation, and USFX, a U.S. resident corporation are all members of a controlled group of taxpayers with B, and each acts as a market maker in foreign currency. In addition to market marking activities conducted in their respective countries, C, D, and USFX each employ marketers and traders, who also perform risk management with respect to their foreign currency operations. In a typical business day, B, C, D, and USFX each enter into several hundred spot and forward contracts to purchase and sell Deutsche marks (DM) with unrelated third parties on the interbank market. In the ordinary course of business, B, C, D, and USFX also each enter into contracts to purchase and sell DM with each other. On a typical day, no more than 10% of USFX's DM trades are with controlled taxpayers. USFX's DM-denominated spot and forward contracts do not vary in their terms, except as to the volume of DM purchased or sold. The differences in volume of DM purchased and sold by USFX do not affect the pricing of the DM. USFX maintains contemporaneous records of its trades, accounted for by type of trade and counterparty. The daily volume of USFX's DM-denominated spot and forward contracts consistently provides USFX with third party transactions that are contemporaneous with the transactions between controlled taxpayers.

(ii) Under §1.482–8(a)(2)(iii), B, C, D, and USFX each are regular dealers in securities because they each regularly and actively offer to, and in fact do, purchase and sell currencies to customers who are not controlled taxpayers, in the ordinary course of their trade or business. Consequently, each controlled taxpayer is also a participant. Together, B, C, D, and USFX conduct a global dealing operation within the meaning of §1.482–8(a)(2)(i) because they execute customer transactions in multiple tax jurisdictions. To determine the comparability of USFX's controlled and uncontrolled DM-denominated spot and forward transactions, the factors in §1.482–8(a)(3) must be considered. USFX performs the same functions with respect to controlled and uncontrolled DM-denominated spot and forward transactions. See §1.482–8(a)(3)(i). In evaluating the contractual terms under §1.482–8(a)(3)(ii), it is determined that the volume of DM transactions varies, but these variances do not affect the pricing of USFX's uncontrolled DM transactions. Taking into account the risk factors of §1.482–8(a)(3)(iii), USFX's risk associated with both the controlled and uncontrolled DM transactions does not vary in any material respect. In applying the significant factors

for evaluating the economic conditions under §1.482-8(a)(3)(iv), USFX has sufficient third party DM transactions to establish comparable economic conditions for evaluating an arm's length price. Accordingly, USFX's uncontrolled transactions are comparable to its controlled transactions in DM spot and forward contracts.

Example 2. Lack of comparable uncontrolled financial transactions. The facts are the same as in Example 1, except that USFX trades Italian lira (lira) instead of DM. USFX enters into few uncontrolled and controlled lira-denominated forward contracts each day. The daily volume of USFX's lira forward purchases and sales does not provide USFX with sufficient third party transactions to establish that uncontrolled transactions are sufficiently contemporaneous with controlled transactions to be comparable within the meaning of §1.482-8(a)(3). In applying the comparability factors of §1.482-8(a)(3), and of paragraph (a)(3)(iv) of this section in particular, USFX's controlled and uncontrolled lira forward purchases and sales are not entered into under comparable economic conditions. Accordingly, USFX's uncontrolled transactions in lira forward contracts are not comparable to its controlled lira forward transactions.

Example 3. Indirect evidence of the price of a comparable uncontrolled financial transaction. (i) The facts are the same as in Example 2, except that USFX uses a computer quotation system (CQS) that is an interdealer market, as described in §1.1092(d)-1(b)(2), to set its price on lira forward contracts with controlled and uncontrolled taxpayers. Other financial institutions also use CQS to set their prices on lira forward contracts. CQS is an established financial market within the meaning of §1.1092(d)-1(b).

(ii) Because CQS is an established financial market, it is a public exchange or quotation media within the meaning of §1.482-8(b)(3)(i). Because other financial institutions use prices from CQS in the same manner as USFX, prices derived from CQS are deemed to be widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales. See §1.482-8(b)(3)(i)(A) and (B). If USFX adjusts the price quoted by CQS under the criteria specified in §1.482-8(b)(2)(ii)(A)(3), the controlled price derived by USFX from CQS qualifies as indirect evidence of the price of a comparable uncontrolled financial transaction.

Example 4. Indirect evidence of the price of a comparable uncontrolled financial transaction—internal pricing models. (i) T is a U.S. resident corporation that acts as a market maker in U.S. dollar-denominated notional principal contracts. T's marketers and traders work together to sell notional principal contracts (NPCs), primarily to T's North and South American customers. T typically earns 4 basis points at the inception of each standard 3 year U.S. dollar-denominated interest rate swap that is entered into with an unrelated, financially sophisticated, creditworthy counterparty. TS, T's wholly owned U.K. subsidiary, also acts as a market maker in U.S. dollar-denominated NPCs, employing several traders and marketers who initiate contracts primarily with European customers. On occasion, for various business reasons, TS enters into a U.S. dollar-denominated NPC with T. The U.S. dollar-denominated NPCs that T enters into with unrelated parties are comparable in all material respects to the transactions that T enters into with TS. TS prices all

transactions with T using the same pricing models that TS uses to price transactions with third parties. The pricing models analyze relevant data, such as interest rates and volatilities, derived from public exchanges. TS records the data that were used to determine the price of each transaction at the time the transaction was entered into. Because the price produced by the pricing models is a mid-market price, TS adjusts the price so that it receives the same 4 basis point spread on its transactions with T that it would earn on comparable transactions with comparable counterparties during the same relevant time period.

(ii) Under §1.482-8(a)(2), T and TS are participants in a global dealing operation that deals in U.S. dollar-denominated NPCs. Because the prices produced by TS's pricing model are derived from information on public exchanges and TS uses the same pricing model to set prices for controlled and uncontrolled transactions, the requirements of §1.482-8(b)(3)(i)(A) and (B) are met. Because the U.S. dollar-denominated NPCs that T enters into with customers (uncontrolled transactions) are comparable to the transactions between T and TS within the meaning of §1.482-8(a)(3) and TS earns 4 basis points at inception of its uncontrolled transactions that are comparable to its controlled transactions, TS has also satisfied the requirements of §1.482-8(b)(3)(i)(C). Accordingly, the price produced by TS's pricing model constitutes indirect evidence of the price of a comparable uncontrolled financial transaction.

(c) *Gross margin method*—(1) *General rule.* The gross margin method evaluates whether the amount allocated to a participant in a global dealing operation is arm's length by reference to the gross profit margin realized on the sale of financial products in comparable uncontrolled transactions. The gross margin method may be used to establish an arm's length price for a transaction where a participant resells a financial product to an unrelated party that the participant purchased from a related party. The gross margin method may apply to transactions involving the purchase and resale of debt and equity instruments. The method may also be used to evaluate whether a participant has received an arm's length commission for its activities in a global dealing operation when the participant has not taken title to a security or has not become a party to a derivative financial product. To meet the arm's length standard, the gross profit margin on controlled transactions should be similar to that of comparable uncontrolled transactions.

(2) *Determination of an arm's length price*—(i) *In general.* The gross margin method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the fi-

nancial product involved in the controlled transaction under review.

(ii) *Applicable resale price.* The applicable resale price is equal to either the price at which the financial product involved is sold in an uncontrolled sale or the price at which contemporaneous resales of the same product are made. If the product purchased in the controlled sale is resold to one or more related parties in a series of controlled sales before being resold in an uncontrolled sale, the applicable resale price is the price at which the product is resold to an uncontrolled party, or the price at which contemporaneous resales of the same product are made. In such case, the determination of the appropriate gross profit will take into account the functions of all members of the controlled group participating in the series of controlled sales and final uncontrolled resales, as well as any other relevant factors described in paragraph (a)(3) of this section.

(iii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin, expressed as a percentage of total revenue derived from sales, earned in comparable uncontrolled transactions.

(3) *Comparability and reliability*—(i) *In general.* The provisions of §1.482-1(d), as modified by paragraph (a)(3) of this section, apply in determining whether a controlled transaction is comparable to a particular uncontrolled transaction. All of the factors described in paragraph (a)(3) of this section must be considered in determining the comparability of two financial products transactions, including the functions performed. The gross margin method considers whether a participant has earned a sufficient gross profit margin on the resale of a financial product (or line of products) given the functions performed by the participant. A reseller's gross profit margin provides compensation for performing resale functions related to the product or products under review, including an operating profit in return for the reseller's investment of capital and the assumption of risks. Accordingly, where a participant does not take title, or does not become a party to a financial product, the reseller's return to capital and assumption of risk are additional factors that must be considered in determining an appropriate gross profit

margin. An appropriate gross profit margin primarily should be derived from comparable uncontrolled purchases and resales of the reseller involved in the controlled sale. This is because similar characteristics are more likely to be found among different resales of a financial product or products made by the same reseller than among sales made by other resellers. In the absence of comparable uncontrolled transactions involving the same reseller, an appropriate gross profit margin may be derived from comparable uncontrolled transactions of other resellers.

(ii) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between controlled and uncontrolled transactions that would affect the gross profit margin, adjustments should be made to the gross profit margin earned in the uncontrolled transaction according to the comparability provisions of §1.482-1(d)(2) and paragraph (a)(3) of this section. For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary because differences in functions performed are often reflected in operating expenses. The effect of a difference in functions performed on gross profit, however, is not necessarily equal to the difference in the amount of related operating expenses.

(iii) *Reliability.* In order for the gross margin method to be considered a reliable measure of an arm's length price, the gross profit should ordinarily represent an amount that would allow the participant who resells the product to recover its expenses (whether directly related to selling the product or more generally related to maintaining its operations) and to earn a profit commensurate with the functions it performed. The gross margin method may be a reliable means of establishing an arm's length price where there is a purchase and resale of a financial product and the participant who resells the property does not substantially participate in developing a product or in tailoring the product to the unique requirements of a customer prior to the resale.

(iv) *Data and assumptions—(A) In general.* The reliability of the results derived from the gross margin method is affected by the completeness and accuracy

of the data used and the reliability of the assumptions made to apply the method. See §1.482-1(c)(2)(ii). A participant may establish the gross margin by comparing the bid and offer prices on a public exchange or quotation media. In such case, the prices must be contemporaneous to the controlled transaction, and the participant must retain records of such data.

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled transactions may affect the reliability of the gross margin method. For example, differences as between controlled and uncontrolled transactions in the method used to value similar financial products (including methods of accounting, methods of estimation, and the timing for changes of such methods) could affect the gross profit. The ability to make reliable adjustments for such differences could affect the reliability of the results.

(4) *Arm's length range.* See §1.482-1(e)(2) and paragraph (a)(4) of this section for the determination of an arm's length range.

(5) *Example.* The following example illustrates the principles of this paragraph (c).

Example 1. Gross margin method. (i) T is a U.S. resident financial institution that acts as a market maker in debt and equity instruments issued by U.S. corporations. Most of T's sales are to U.S.-based customers. TS, T's U.K. subsidiary, acts as a market maker in debt and equity instruments issued by European corporations and conducts most of its business with European-based customers. On occasion, however, a customer of TS wishes to purchase a security that is either held by or more readily accessible to T. To facilitate this transaction, T sells the security it owns or acquires to TS, who then promptly sells it to the customer. T and TS generally derive the majority of their profit on the difference between the price at which they purchase and the price at which they sell securities (the bid/offer spread). On average, TS's gross profit margin on its purchases and sales of securities from unrelated persons is 2%. Applying the comparability factors specified in §1.482-8(a)(3), T's purchases and sales with unrelated persons are comparable to the purchases and sales between T and TS.

(ii) Under §1.482-8(a)(2), T and TS are participants in a global dealing operation that deals in debt and equity securities. Since T's related purchases and sales are comparable to its unrelated purchases and sales, if TS's gross profit margin on purchases and sales of comparable securities from unrelated persons is 2%, TS should also typically earn a 2% gross profit on the securities it purchases from T. Thus, when TS resells for \$100 a security that it purchased from T, the arm's length price at which TS

would have purchased the security from T would normally be \$98 (\$100 sales price minus (2% gross profit margin \times \$100)).

(d) *Gross markup method—(1) General rule.* The gross markup method evaluates whether the amount allocated to a participant in a global dealing operation is arm's length by reference to the gross profit markup realized in comparable uncontrolled transactions. The gross markup method may be used to establish an arm's length price for a transaction where a participant purchases a financial product from an unrelated party that the participant sells to a related party. This method may apply to transactions involving the purchase and resale of debt and equity instruments. The method may also be used to evaluate whether a participant has received an arm's length commission for its role in a global dealing operation when the participant has not taken title to a security or has not become a party to a derivative financial product. To meet the arm's length standard, the gross profit markup on controlled transactions should be similar to that of comparable uncontrolled transactions.

(2) *Determination of an arm's length price—(i) In general.* The gross markup method measures an arm's length price by adding the appropriate gross profit to the participant's cost or anticipated cost, of purchasing, holding, or structuring the financial product involved in the controlled transaction under review (or in the case of a derivative financial product, the initial net present value, measured by the anticipated cost of purchasing, holding, or structuring the product).

(ii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the participant's cost or anticipated cost of purchasing, holding, or structuring a transaction by the gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions.

(3) *Comparability and reliability—(i) In general.* The provisions of §1.482-1(d), as modified by paragraph (a)(3) of this section, apply in determining whether a controlled transaction is comparable to a particular uncontrolled transaction. All of the factors described in paragraph (a)(3) of this section must be considered in determining the comparability of two financial products transactions, including the

functions performed. The gross markup method considers whether a participant has earned a sufficient gross markup on the sale of a financial product, or line of products, given the functions it has performed. A participant's gross profit markup provides compensation for purchasing, hedging, and transactional structuring functions related to the transaction under review, including an operating profit in return for the investment of capital and the assumption of risks. Accordingly, where a participant does not take title, or does not become a party to a financial product, the reseller's return to capital and assumption of risk are additional factors that must be considered in determining the gross profit markup. An appropriate gross profit markup primarily should be derived from comparable uncontrolled purchases and sales of the participant involved in the controlled sale. This is because similar characteristics are more likely to be found among different sales of property made by the same participant than among sales made by other resellers. In the absence of comparable uncontrolled transactions involving the same participant, an appropriate gross profit markup may be derived from comparable uncontrolled transactions of other parties whether or not such parties are members of the same controlled group.

(ii) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between controlled and uncontrolled transactions that would affect the gross profit markup, adjustments should be made to the gross profit markup earned in the uncontrolled transaction according to the comparability provisions of §1.482-1(d)(2) and paragraph (a)(3) of this section. For this purpose, consideration of operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. The effect of a difference in functions on gross profit, however, is not necessarily equal to the difference in the amount of related operating expenses.

(iii) *Reliability.* In order for the gross markup method to be considered a reliable measure of an arm's length price, the gross profit should ordinarily represent an amount that would allow the participant

who purchases the product to recover its expenses (whether directly related to selling the product or more generally related to maintaining its operations) and to earn a profit commensurate with the functions it performed. As with the gross margin method, the gross markup method may be a reliable means of establishing an arm's length price where there is a purchase and resale of a financial product and the participant who resells the property does not substantially participate in developing a product or in tailoring the product to the unique requirements of a customer prior to the resale.

(iv) *Data and assumptions—(A) In general.* The reliability of the results derived from the gross markup method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See §1.482-1(c)(2)(ii). A participant may establish the gross markup by comparing the bid and offer prices on a public exchange or quotation media. In such case, the prices must be contemporaneous with the controlled transaction, and the participant must retain records of such data.

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled transactions may affect the reliability of the gross markup method. For example, differences as between controlled and uncontrolled transactions in the method used to value similar financial products (including methods in accounting, methods of estimation, and the timing for changes of such methods) could affect the gross profit. The ability to make reliable adjustments for such differences could affect the reliability of the results.

(4) *Arm's length range.* See §1.482-1(e)(2) and paragraph (a)(4) of this section for the determination of an arm's length range.

(e) *Profit split method—(1) General rule.* The profit split method evaluates whether the allocation of the combined operating profit or loss of a global dealing operation to one or more participants is at arm's length by reference to the relative value of each participant's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the partic-

ipants for which data is available that includes the controlled transactions (relevant business activity).

(2) *Appropriate share of profit and loss—(i) In general.* The relative value of each participant's contribution to the global dealing activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the activity, consistent with the comparability provisions of §1.482-1(d), as modified by paragraph (a)(3) of this section. Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity. The relative value of the contributions of each participant in the global dealing operation should be measured in a manner that most reliably reflects each contribution made to the global dealing operation and each participant's role in that contribution. In appropriate cases, the participants may find that a multi-factor formula most reliably measures the relative value of the contributions to the profitability of the global dealing operation. The profit allocated to any particular participant using a profit split method is not necessarily limited to the total operating profit from the global dealing operation. For example, in a given year, one participant may earn a profit while another participant incurs a loss, so long as the arrangement is comparable to an arrangement to which two uncontrolled parties would agree. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally or in any other arbitrary proportion. The specific method must be determined under paragraph (e)(4) of this section.

(ii) *Adjustment of factors to measure contribution clearly.* In order to reliably measure the value of a participant's contribution, the factors, for example, those used in a multi-factor formula, must be expressed in units of measure that reliably quantify the relative contribution of the participant. If the data or information is influenced by factors other than the value of the contribution, adjustments must be made for such differences so that the fac-

tors used in the formula only measure the relative value of each participant's contribution. For example, if trader compensation is used as a factor to measure the value added by the participants' trading expertise, adjustments must be made for variances in compensation paid to traders due solely to differences in the cost of living.

(3) *Definitions.* The definitions in this paragraph (e)(3) apply for purposes of applying the profit split methods in this paragraph (e).

Gross profit is gross income earned by the global dealing operation.

Operating expenses includes all expenses not included in the computation of gross profit, except for interest, foreign income taxes as defined in §1.901-2(a), domestic income taxes, and any expenses not related to the global dealing activity that is evaluated under the profit split method. With respect to interest expense, see section 864(e) and the regulations thereunder and §1.882-5.

Operating profit or loss is gross profit less operating expenses, and includes all income, expense, gain, loss, credits or allowances attributable to each global dealing activity that is evaluated under the profit split method. It does not include income, expense, gain, loss, credits or allowances from activities that are not evaluated under the profit split method, nor does it include extraordinary gains or losses that do not relate to the continuing global dealing activities of the participant.

(4) *Application.* Profit or loss shall be allocated under the profit split method using either the total profit split, described in paragraph (e)(5) of this section, or the residual profit split, described in paragraph (e)(6) of this section.

(5) *Total profit split*—(i) *In general.* The total profit split derives the percentage of the combined operating profit of the participants in a global dealing operation allocable to a participant in the global dealing operation by evaluating whether uncontrolled taxpayers who perform similar functions, assume similar risks, and employ similar resources would allocate their combined operating profits in the same manner.

(ii) *Comparability.* The total profit split evaluates the manner by which comparable uncontrolled taxpayers divide the combined operating profit of a particular global dealing activity. The degree of

comparability between the controlled and uncontrolled taxpayers is determined by applying the comparability standards of §1.482-1(d), as modified by paragraph (a)(3) of this section. In particular, the functional analysis required by §1.482-1(d)(3)(i) and paragraph (a)(3)(i) of this section is essential to determine whether two situations are comparable. Nevertheless, in certain cases, no comparable ventures between uncontrolled taxpayers may exist. In this situation, it is necessary to analyze the remaining factors set forth in paragraph (a)(3) of this section that could affect the division of operating profits between parties. If there are differences between the controlled and uncontrolled taxpayers that would materially affect the division of operating profit, adjustments must be made according to the provisions of §1.482-1(d)(2) and paragraph (a)(3) of this section.

(iii) *Reliability.* As indicated in §1.482-1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the reliability of a total profit split also increases. In a global dealing operation, however, the absence of external market benchmarks (for example, joint ventures between uncontrolled taxpayers) on which to base the allocation of operating profits does not preclude use of this method if the allocation of the operating profit takes into account the relative contribution of each participant. The reliability of this method is increased to the extent that the allocation has economic significance for purposes other than tax (for example, satisfying regulatory standards and reporting, or determining bonuses paid to management or traders). The reliability of the analysis under this method may also be enhanced by the fact that all parties to the controlled transaction are evaluated under this method. The reliability of the results, however, of an analysis based on information from all parties to a transaction is affected by the reliability of the data and assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(iv) *Data and assumptions*—(A) *In general.* The reliability of the results de-

rived from the total profit split method is affected by the quality of the data used and the assumptions used to apply the method. See §1.482-1(c)(2)(ii). The reliability of the allocation of income, expense, or other attributes between the participants' relevant business activities and the participants' other activities will affect the reliability of the determination of the combined operating profit and its allocation among the participants. If it is not possible to allocate income, expense, or other attributes directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from application of this method is reduced relative to the results of a method that requires fewer allocations of income, expense, and other attributes. Similarly, the reliability of the results derived from application of this method is affected by the extent to which it is possible to apply the method to the participants' financial data that is related solely to the controlled transactions. For example, if the relevant business activity is entering into interest rate swaps with both controlled and uncontrolled taxpayers, it may not be possible to apply the method solely to financial data related to the controlled transactions. In such case, the reliability of the results derived from application of this method will be reduced.

(B) *Consistency in accounting.* The degree of consistency between the controlled and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit affects the reliability of the result. Thus, for example, if differences in financial product valuation or in cost allocation practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results.

(6) *Residual profit split*—(i) *In general.* The residual profit split allocates the combined operating profit or loss between participants following the two-step process set forth in paragraphs (e)(6)(ii) and (iii) of this section.

(ii) *Allocate income to routine contributions.* The first step allocates operating income to each participant to provide an arm's length return for its routine contributions to the global dealing operation.

Routine contributions are contributions of the same or similar kind as those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services, and intangibles that are generally owned or performed by uncontrolled taxpayers engaged in similar activities. For example, transactions processing and credit analysis are typically routine contributions. In addition, a participant that guarantees obligations of or otherwise provides credit support to another controlled taxpayer in a global dealing operation is regarded as making a routine contribution. A functional analysis is required to identify the routine contributions according to the functions performed, risks assumed, and resources employed by each of the participants. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with the methods described in §§1.482–2 through 1.482–4 and this §1.482–8.

(iii) *Allocate residual profit.* The allocation of income to the participant's routine contributions will not reflect profits attributable to each participant's valuable nonroutine contributions to the global dealing operation. Thus, in cases where valuable nonroutine contributions are present, there normally will be an unallocated residual profit after the allocation of income described in paragraph (e)(6)(ii) of this section. Under this second step, the residual profit generally should be divided among the participants based upon the relative value of each of their nonroutine contributions. Nonroutine contributions are contributions so integral to the global dealing operation that it is impossible to segregate them from the operation and find a separate market return for the contribution. Pricing and risk managing financial products almost invariably involve nonroutine contributions. Similarly, product development and information technology are generally nonroutine contributions. Marketing may be a nonroutine contribution if the marketer substantially participates in developing a product or in tailoring the product to the unique requirements of a customer. The relative value of the nonroutine contribu-

tions of each participant in the global dealing operation should be measured in a manner that most reliably reflects each nonroutine contribution made to the global dealing operation and each participant's role in the nonroutine contributions.

(iv) *Comparability.* The first step of the residual profit split relies on external market benchmarks of profitability. Thus, the comparability considerations that are relevant for the first step of the residual profit split are those that are relevant for the methods that are used to determine market returns for routine contributions. In the second step of the residual profit split, however, it may not be possible to rely as heavily on external market benchmarks. Nevertheless, in order to divide the residual profits of a global dealing operation in accordance with each participant's nonroutine contributions, it is necessary to apply the comparability standards of §1.482–1(d), as modified by paragraph (a)(3) of this section. In particular, the functional analysis required by §1.482–1(d)(3)(i) and paragraph (a)(3)(i) of this section is essential to determine whether two situations are comparable. Nevertheless, in certain cases, no comparable ventures between uncontrolled taxpayers may exist. In this situation, it is necessary to analyze the remaining factors set forth in paragraph (a)(3) of this section that could affect the division of operating profits between parties. If there are differences between the controlled and uncontrolled taxpayers that would materially affect the division of operating profit, adjustments must be made according to the provisions of §1.482–1(d)(2) and paragraph (a)(3) of this section.

(v) *Reliability.* As indicated in §1.482–1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the reliability of a residual profit split also increases. In a global dealing operation, however, the absence of external market benchmarks (for example, joint ventures between uncontrolled taxpayers) on which to base the allocation of operating profits does not preclude use of this method if the allocation of the residual profit takes into account the relative contribution of each participant. The reliability of this method is increased to the extent that the allocation has economic significance for purposes

other than tax (for example, satisfying regulatory standards and reporting, or determining bonuses paid to management or traders). The reliability of the analysis under this method may also be enhanced by the fact that all parties to the controlled transaction are evaluated under this method. The reliability of the results, however, of an analysis based on information from all parties to a transaction is affected by the reliability of the data and assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(vi) *Data and assumptions—(A) General rule.* The reliability of the results derived from the residual profit split is measured under the standards set forth in paragraph (e)(5)(iv)(A) of this section.

(B) *Consistency in accounting.* The degree of accounting consistency between controlled and uncontrolled taxpayers is measured under the standards set forth in paragraph (e)(5)(iv)(B) of this section.

(7) *Arm's length range.* See §1.482–1(e)(2) and paragraph (a)(4) of this section for the determination of an arm's length range.

(8) *Examples.* The following examples illustrate the principles of this paragraph (e).

Example 1. Total profit split. (i) P, a U.S. corporation, establishes a separate U.S. subsidiary (USub) to conduct a global dealing operation in over-the-counter derivatives. USub in turn establishes subsidiaries incorporated and doing business in the U.K. (UKsub) and Japan (Jsub). USub, UKsub, and Jsub each employ marketers and traders who work closely together to design and sell derivative products to meet the particular needs of customers. Each also employs personnel who process and confirm trades, reconcile trade tickets and provide ongoing administrative support (back office services) for the global dealing operation. The global dealing operation maintains a single common book for each type of risk, and the book is maintained where the head trader for that type of risk is located. Thus, notional principal contracts denominated in North and South American currencies are booked in USub, notional principal contracts denominated in European currencies are booked in UKsub, and notional principal contracts denominated in Japanese yen are booked in Jsub. However, each of the affiliates has authorized a trader located in each of the other affiliates to risk manage its books during periods when the booking location is closed. This grant of authority is necessary because marketers, regardless of their location, are expected to sell all of the group's

products, and need to receive pricing information with respect to products during their clients' business hours, even if the booking location is closed. Moreover, P is known for making a substantial amount of its profits from trading activities, and frequently does not hedge the positions arising from its customer transactions in an attempt to profit from market changes. As a result, the traders in "off-hours" locations must have a substantial amount of trading authority in order to react to market changes.

(ii) Under §1.482-8(a)(2), USsub, UKsub and Jsub are participants in a global dealing operation in over-the-counter derivatives. P determines that the total profit split method is the best method to allocate an arm's length amount of income to each participant. P allocates the operating profit from the global dealing operation between USsub, UKsub and Jsub on the basis of the relative compensation paid to marketers and traders in each location. In making the allocation, P adjusts the compensation amounts to account for factors unrelated to job performance, such as the higher cost of living in certain jurisdictions. Because the traders receive significantly greater compensation than marketers in order to account for their greater contribution to the profits of the global dealing operation, P need not make additional adjustments or weight the compensation of the traders more heavily in allocating the operating profit between the affiliates. For rules concerning the source of income allocated to USsub, UKsub and Jsub (and any U.S. trade or business of the participants), see §1.863-3(h).

Example 2. Total profit split. The facts are the same as in Example 1, except that the labor market in Japan is such that traders paid by Jsub are paid the same as marketers paid by Jsub at the same seniority level, even though the traders contribute substantially more to the profitability of the global dealing operation. As a result, the allocation method used by P is unlikely to compensate the functions provided by each affiliate so as to be a reliable measure of an arm's length result under §§1.482-8(e)(2) and 1.482-1(c)(1), unless P weights the compensation of traders more heavily than the compensation of marketers or develops another method of measuring the contribution of traders to the profitability of the global dealing operation.

Example 3. Total profit split. The facts are the same as in Example 2, except that, in P's annual report to shareholders, P divides its operating profit from customer business into "dealing profit" and "trading profit." Because both marketers and traders are involved in the dealing function, P divides the "dealing profit" between the affiliates on the basis of the relative compensation of marketers and traders. However, because only the traders contribute to the trading profit, P divides the trading profit between the affiliates on the basis of the relative compensation only of the traders. In making that allocation, P must adjust the compensation of traders in Jsub in order to account for factors not related to job performance.

Example 4. Total profit split. The facts are the same as in Example 1, except that P is required by its regulators to hedge its customer positions as much as possible and therefore does not earn any "trading profit." As a result, the marketing intangibles, such as customer relationships, are relatively more important than the intangibles used by traders. Accordingly, P must weight the compensation of

marketers more heavily than the compensation of traders in order to take into account accurately the contribution each function makes to the profitability of the business.

Example 5. Residual profit split. (i) P is a U.S. corporation that engages in a global dealing operation in foreign currency options directly and through controlled taxpayers that are incorporated and operate in the United Kingdom (UKsub) and Japan (Jsub). Each controlled taxpayer is a participant in a global dealing operation. Each participant employs marketers and traders who work closely together to design and sell foreign currency options that meet the particular needs of customers. Each participant also employs salespeople who sell foreign currency options with standardized terms and conditions, as well as other financial products offered by the controlled group. The traders in each location risk manage a common book of transactions during the relevant business hours of each location. P has a AAA credit rating and is the legal counterparty to all third party transactions. The traders in each location have discretion to execute contracts in the name of P. UKsub employs personnel who process and confirm trades, reconcile trade tickets, and provide ongoing administrative support (back office services) for all the participants in the global dealing operation. The global dealing operation has generated \$192 of operating profit for the period.

(ii) After analyzing the foreign currency options business, P has determined that the residual profit split method is the best method to allocate the operating profit of the global dealing operation and to determine an arm's length amount of compensation allocable to each participant in the global dealing operation.

(iii) The first step of the residual profit split method (§1.482-8(e)(6)(ii)) requires P to identify the routine contributions performed by each participant. P determines that the functions performed by the salespeople are routine. P determines that the arm's length compensation for salespeople is \$3, \$4, and \$5 in the United States, the United Kingdom, and Japan, respectively. Thus, P allocates \$3, \$4, and \$5 to P, UKsub, and Jsub, respectively.

(iv) Although the back office function would not give rise to participant status, in the context of a residual profit split allocation, the back office function is relevant for purposes of receiving remuneration for routine contributions to a global dealing operation. P determines that an arm's length compensation for the back office is \$20. Since the back office services constitute routine contributions, \$20 of income is allocated to UKsub under step 1 of the residual profit split method. In addition, P determines that the comparable arm's length compensation for the risk to which P is subject as counterparty is \$40. Accordingly, \$40 is allocated to P as compensation for acting as counterparty to the transactions entered into in P's name by Jsub and UKsub.

(v) The second step of the residual profit split method (§1.482-8(e)(6)(iii)) requires that the residual profit be allocated to participants according to the relative value of their nonroutine contributions. Under P's transfer pricing method, P allocates the residual profit of \$120 (\$192 gross income minus \$12 salesperson commissions minus \$20 payment for back office services minus \$40 compensation for the routine contribution of acting as counterparty) using a multi-factor formula that reflects the relative

value of the nonroutine contributions. Applying the comparability factors set out in §1.482-8(a)(3), P allocates 40% of the residual profit to UKsub, 35% of the residual profit to P, and the remaining 25% of residual profit to Jsub. Accordingly, under step 2, \$48 is allocated to UKsub, \$42 is allocated to P, and \$30 is allocated to Jsub. See § 1.863-3(h) for the source of income allocated to P with respect to its counterparty function.

(f) *Unspecified methods.* Methods not specified in paragraphs (b),(c),(d), or (e) of this section may be used to evaluate whether the amount charged in a controlled transaction is at arm's length. Any method used under this paragraph (f) must be applied in accordance with the provisions of §1.482-1 as modified by paragraph (a)(3) of this section.

(g) *Source rule for qualified business units.* See §1.863-3(h) for application of the rules of this section for purposes of determining the source of income, gain or loss from a global dealing operation among qualified business units (as defined in section 989(c) and §§1.863-3(h)(3)(iv) and 1.989(a)-1).

Par. 7. Section 1.863-3 is amended as follows:

1. Paragraph (h) is redesignated as paragraph (i).

2. A new paragraph (h) is added.

The addition reads as follows:

§1.863-3 Allocation and apportionment of income from certain sales of inventory.

* * * * *

(h) *Income from a global dealing operation—(1) Purpose and scope.* This paragraph (h) provides rules for sourcing income, gain and loss from a global dealing operation that, under the rules of §1.482-8, is earned by or allocated to a controlled taxpayer qualifying as a participant in a global dealing operation under §1.482-8(a)(2)(ii). This paragraph (h) does not apply to income earned by or allocated to a controlled taxpayer qualifying as a participant in a global dealing operation that is specifically sourced under sections 861, 862 or 865, or to substitute payments earned by a participant in a global dealing operation that are sourced under §1.861-2(a)(7) or §1.861-3(a)(6).

(2) *In general.* The source of any income, gain or loss to which this section applies shall be determined by reference to the residence of the participant. For purposes of this paragraph (h), the resi-

dence of a participant shall be determined under section 988(a)(3)(B).

(3) *Qualified business units as participants in global dealing operations*—(i) *In general.* Except as otherwise provided in this paragraph (h), where a single controlled taxpayer conducts a global dealing operation through one or more qualified business units (QBUs), as defined in section 989(a) and §1.989(a)–1, the source of income, gain or loss generated by the global dealing operation and earned by or allocated to the controlled taxpayer shall be determined by applying the rules of §1.482–8 as if each QBU that performs activities of a regular dealer in securities as defined in §1.482–8(a)(2)(ii)(A) or the related activities described in §1.482–8(a)(2)(ii)(B) were a separate controlled taxpayer qualifying as a participant in the global dealing operation within the meaning of §1.482–8(a)(2)(ii). Accordingly, the amount of income sourced in the United States and outside of the United States shall be determined by treating the QBU as a participant in the global dealing operation, allocating income to each participant under §1.482–8, as modified by paragraph (h)(3)(ii) of this section, and sourcing the income to the United States or outside of the United States under §1.863–3(h)(2).

(ii) *Economic effects of a single legal entity.* In applying the principles of §1.482–8, the taxpayer shall take into account the economic effects of conducting a global dealing operation through a single entity instead of multiple legal entities. For example, since the entire capital of a corporation supports all of the entity's transactions, regardless of where those transactions may be booked, the payment of a guarantee fee within the entity is inappropriate and will be disregarded.

(iii) *Treatment of interbranch and interdesk amounts.* An agreement among QBUs of the same taxpayer to allocate income, gain or loss from transactions with third parties is not a transaction because a taxpayer cannot enter into a contract with itself. For purposes of this paragraph (h)(3), however, such an agreement, including a risk transfer agreement (as defined in §1.475(g)–2(b)) may be used to determine the source of global dealing income from transactions with third parties in the same manner and to the same extent

that transactions between controlled taxpayers in a global dealing operation may be used to allocate income, gain or loss from the global dealing operation under the rules of §1.482–8.

(iv) *Deemed QBU.* For purposes of this paragraph (h)(3), a QBU shall include a U.S. trade or business that is deemed to exist because of the activities of a dependent agent in the United States, without regard to the books and records requirement of §1.989(a)–1(b).

(v) *Examples.* The following examples illustrate this paragraph (h)(3).

Example 1. Use of comparable uncontrolled financial transactions method to source global dealing income between branches. (i) F is a foreign bank that acts as a market maker in foreign currency through branch offices in London, New York, and Tokyo. In a typical business day, the foreign exchange desk in F's U.S. branch (USFX) enters into several hundred spot and forward contracts on the interbank market to purchase and sell Deutsche marks (DM) with unrelated third parties. Each of F's branches, including USFX, employs both marketers and traders for their foreign currency dealing. In addition, USFX occasionally transfers risk with respect to its third party DM contracts to F's London and Tokyo branches. These interbranch transfers are entered into in the same manner as trades with unrelated third parties. On a typical day, risk management responsibility for no more than 10% of USFX's DM trades are transferred interbranch. F records these transfers by making notations on the books of each branch that is a party to the transfers. The accounting procedures are nearly identical to those followed when a branch enters into an offsetting hedge with a third party. USFX maintains contemporaneous records of its interbranch transfers and third party transactions, separated according to type of trade and counterparty. Moreover, the volume of USFX's DM spot purchases and sales each day consistently provides USFX with third party transactions that are contemporaneous with the transfers between the branches.

(ii) As provided in paragraph (h)(3)(i) of this section, USFX and F's other branches that trade DM are participants in a global dealing operation. Accordingly, the principles of §1.482–8 apply in determining the source of income earned by F's qualified business units that are participants in a global dealing operation. Applying the comparability factors in §1.482–8(a)(3) shows that USFX's interbranch transfers and uncontrolled DM-denominated spot and forward contracts have no material differences. Because USFX sells DM in uncontrolled transactions and transfers risk management responsibility for DM-denominated contracts, and the uncontrolled transactions and interbranch transfers are consistently entered into contemporaneously, the interbranch transfers provide a reliable measure of an arm's length allocation of third party income from F's global dealing operation in DM-denominated contracts. This allocation of third party income is treated as U.S. source in accordance with §§1.863–3(h) and 1.988–4(h) and accordingly will

be treated as income effectively connected with F's U.S. trade or business under §1.864–4.

Example 2. Residual profit split between branches. (i) F is a bank organized in country X that has a AAA credit rating and engages in a global dealing operation in foreign currency options through branch offices in London, New York, and Tokyo. F has dedicated marketers and traders in each branch who work closely together to design and sell foreign currency options that meet the particular needs of customers. Each branch also employs general salespeople who sell standardized foreign currency options, as well as other financial products and foreign currency offered by F. F's traders work from a common book of transactions that is risk managed at each branch during local business hours. Accordingly, all three branches share the responsibility for risk managing the book of products. Personnel in the home office of F process and confirm trades, reconcile trade tickets, and provide ongoing administrative support (back office services) for the other branches. The global dealing operation has generated \$223 of operating profit for the period.

(ii) Under §1.863–3(h), F applies §1.482–8 to allocate global dealing income among its branches, because F's London, New York, and Tokyo branches are treated as participants in a global dealing operation that deals in foreign currency options under §1.482–8(a)(2). After analyzing the foreign currency options business, F has determined that the residual profit split method is the best method to determine an arm's length amount of compensation allocable to each participant in the global dealing operation.

(iii) Under the first step of the residual profit split method (§1.482–8(e)(6)(ii)), F identifies and compensates the routine contributions performed by each participant. F determines that an arm's length compensation for general salespeople is \$3, \$4, and \$5 in New York, London, and Tokyo, respectively, and that the home office incurred \$11 of expenses in providing the back office services. Since F's capital legally supports all of the obligations of the branches, no amount is allocated to the home office of F for the provision of capital.

(iv) The second step of the residual profit split method (§1.482–8(e)(6)(iii)) requires that the residual profit be allocated to participants according to their nonroutine contributions. F determines that a multi-factor formula best reflects these contributions. After a detailed functional analysis, and applying the comparability factors in §1.482–8(a)(3), 40% of the residual profit is allocated to the London branch, 35% to the New York branch, and the remaining 25% to the Tokyo branch. Thus, the residual profit of \$200 (\$223 operating profit minus \$12 general salesperson commissions minus \$11 back office allocation) is allocated \$80 to London (40% allocation x \$200), \$70 to New York (35% x \$200) and \$50 to Tokyo (25% x \$200).

Example 3. Residual profit split—deemed branches. (i) P, a U.K. corporation, conducts a global dealing operation in notional principal contracts, directly and through a U.S. subsidiary (USsub) and a Japanese subsidiary (Jsub). P is the counterparty to all transactions entered into with third parties. P, USsub, and Jsub each employ marketers and traders who work closely together to design and sell derivative products to meet the particu-

lar needs of customers. USsub also employs personnel who process and confirm trades, reconcile trade tickets and provide ongoing administrative support (back office services) for the global dealing operation. The global dealing operation maintains a single common book for each type of risk, and the book is maintained where the head trader for that type of risk is located. However, P, USsub, and Jsub have authorized a trader located in each of the other affiliates to risk manage its books during periods when the primary trading location is closed. This grant of authority is necessary because marketers, regardless of their location, are expected to sell all of the group's products, and need to receive pricing information with respect to products during their clients' business hours, even if the booking location is closed. The global dealing operation has generated \$180 of operating profit for the period.

(ii) Because employees of USsub have authority to enter into contracts in the name of P, P is treated as being engaged in a trade or business in the United States through a deemed QBU. §1.863-3(h)(3)(iv). Similarly, under U.S. principles, P would be treated as being engaged in business in Japan through a QBU. Under §1.482-8(a)(2), P, USsub, and Jsub are participants in the global dealing operation relating to notional principal contracts. Additionally, under §1.863-3(h)(3), the U.S. and Japanese QBUs are treated as participants in a global dealing operation for purposes of sourcing the income from that operation. Under §1.863-3(h), P applies the methods in §1.482-8 to determine the source of income allocated to the U.S. and non-U.S. QBUs of P.

(iii) After analyzing the notional principal contract business, P has concluded that the residual profit split method is the best method to allocate income under §1.482-8 and to source income under §1.863-3(h).

(iv) Under the first step of the residual profit split method (§1.482-8(e)(6)(ii)), P identifies and compensates the routine contributions performed by each participant. Although the back office function does not give rise to participant status, in the context of a residual profit split allocation, the back office function is relevant for purposes of receiving remuneration for a routine contribution to a global dealing operation. P determines that an arm's length compensation for the back office is \$20. Since the back office services constitute a routine contribution, \$20 of income is allocated to USsub under step 1 of the residual profit split method. Similarly, as the arm's length compensation for the risk to which P is subject as counterparty is \$40, \$40 is allocated to P as compensation for acting as counterparty.

(v) The second step of the residual profit split method (§1.482-8(e)(6)(iii)) requires that the residual profit be allocated to participants according to the relative value of their nonroutine contributions. Under P's transfer pricing method, P allocates the residual profit of \$120 (\$180 gross income minus \$20 for back office services minus \$40 compensation for the routine contribution of acting as counterparty) using a multi-factor formula that reflects the relative value of the nonroutine contributions. Applying the comparability factors set out in §1.482-8(a)(3), P allocates 40% of the residual profit to P, 35% of the residual profit to USsub, and the remaining 25% of residual profit to Jsub. Accordingly, under step 2, \$48 is allocated to P, \$42 is allocated to USsub, and \$30 is allocated to Jsub. Under §1.863-

3(h), the amounts allocated under the residual profit split is sourced according to the residence of each participant to which it is allocated.

(vi) Because the \$40 allocated to P consists of compensation for the use of capital, the allocation is sourced according to where the capital is employed. Accordingly, the \$40 is sourced 35% to P's deemed QBU in the United States under §1.863-3(h)(3)(iv) and 65% to non-U.S. sources.

* * * * *

Par. 8. Section 1.863-7(a)(1) is amended by revising the second sentence to read as follows:

§1.863-7 Allocation of income attributable to certain notional principal contracts under section 863(a).

(a) *Scope—(1) Introduction.* * * * This section does not apply to income from a section 988 transaction (as defined in section 988(c) and §1.988-1(a)), or to income from a global dealing operation (as defined in §1.482-8(a)(2)(i)) that is sourced under the rules of §1.863-3(h). * * *

* * * * *

Par. 9. Section 1.864-4 is amended as follows:

1. Paragraphs (c)(2)(iv), (c)(2)(v), (c)(3)(ii), and (c)(5)(vi)(a) and (b) are redesignated as (c)(2)(v), (c)(2)(vi), (c)(3)(iii), and (c)(5)(vi)(b) and (c), respectively.

2. New paragraphs (c)(2)(iv), (c)(3)(ii), and (c)(5)(vi)(a) are added.

The additions read as follows:

§1.864-4 U.S. source income effectively connected with U.S. business.

* * * * *

(c) * * *

(2) * * *

(iv) *Special rule relating to a global dealing operation.* An asset used in a global dealing operation, as defined in §1.482-8(a)(2)(i), will be treated as an asset used in a U.S. trade or business only if and to the extent that the U.S. trade or business is a participant in the global dealing operation under §1.863-3(h)(3), and income, gain or loss produced by the asset is U.S. source under §1.863-3(h) or would be treated as U.S. source if §1.863-3(h) were to apply to such amounts.

* * * * *

(3) * * *

(ii) *Special rule relating to a global dealing operation.* A U.S. trade or business shall be treated as a material factor in the realization of income, gain or loss derived in a global dealing operation, as defined in §1.482-8(a)(2)(i), only if and to the extent that the U.S. trade or business is a participant in the global dealing operation under §1.863-3(h)(3), and income, gain or loss realized by the U.S. trade or business is U.S. source under §1.863-3(h) or would be treated as U.S. source if §1.863-3(h) were to apply to such amounts.

* * * * *

(5) * * *

(vi) * * *

(a) *Certain income earned by a global dealing operation.* Notwithstanding paragraph (c)(5)(ii) of this section, U.S. source interest, including substitute interest as defined in §1.861-2(a)(7), and dividend income, including substitute dividends as defined in §1.861-3(a)(6), derived by a participant in a global dealing operation, as defined in §1.482-8(a)(2)(i), shall be treated as attributable to the foreign corporation's U.S. trade or business, only if and to the extent that the income would be treated as U.S. source if §1.863-3(h) were to apply to such amounts.

Par. 10. Section 1.864-6 is amended as follows:

1. Paragraph (b)(2)(ii)(d)(3) and (b)(3)(ii)(c) are added.

2. Paragraph (b)(3)(i) is revised by adding a new sentence after the last sentence.

The additions and revision read as follows:

§1.864-6 Income, gain or loss attributable to an office or other fixed place of business in the United States.

* * * * *

(b) * * *

(2) * * *

(ii) * * *

(d) * * *

(3) *Certain income earned by a global dealing operation.* Notwithstanding paragraphs (b)(2)(ii)(a) or (b) of this section, foreign source interest, including substitute interest as defined in §1.861-2(a)(7), or dividend income, including substitute dividends as defined in §1.861-3(a)(6), derived by a participant in a global deal-

ing operation, as defined in §1.482–8(a)(2)(i) shall be treated as attributable to the foreign corporation's U.S. trade or business only if and to the extent that the income would be treated as U.S. source if §1.863–3(h) were to apply to such amounts. * * *

(3) * * *

(i) * * * Notwithstanding paragraphs (b)(3)(i)(I) and (2) of this section, an office or other fixed place of business of a nonresident alien individual or a foreign corporation which is located in the United States and which is a participant in a global dealing operation, as defined in §1.482–8(a)(2)(i), shall be considered to be a material factor in the realization of foreign source income, gain or loss, only if and to the extent that such income, gain or loss would be treated as U.S. source if §1.863–3(h) were to apply to such amounts.

(ii) * * *

(c) *Property sales in a global dealing operation.* Notwithstanding paragraphs (b)(3)(ii)(a) or (b) of this section, personal property described in section 1221(1) and sold in the active conduct of a taxpayer's global dealing operation, as defined in §1.482–8(a)(2)(i), shall be presumed to have been sold for use, consumption, or disposition outside of the United States only if and to the extent that the income, gain or loss to which the sale gives rise would be sourced outside of the United States if §1.863–3(h) were to apply to such amounts.

Par. 11. Section 1.894–1 is amended as follows:

1. Paragraph (d) is redesignated as paragraph (e).

2. New paragraph (d) is added.

The addition reads as follows:

§1.894–1 Income affected by treaty.

* * * * *

(d) *Income from a global dealing operation.* If a taxpayer that is engaged in a global dealing operation, as defined in §1.482–8(a)(2)(i), has a permanent establishment in the United States under the principles of an applicable U.S. income tax treaty, the principles of §1.863–3(h), §1.864–4(c)(2)(iv), §1.864–4(c)(3)(ii), §1.864–4(c)(5)(vi)(a) or §1.864–6(b)(2)(ii)(d)(3) shall apply for purposes of determining the income attributable to that U.S. permanent establishment.

* * * * *

Par. 12. Section 1.988–4 is amended as follows:

1. Paragraph (h) is redesignated as paragraph (i).

2. A new paragraph (h) is added.

The addition and revision read as follows:

§1.988–4 Source of gain or loss realized on a section 988 transfer.

* * * * *

(h) *Exchange gain or loss from a global dealing operation.* Notwithstanding the provisions of this section, exchange gain or loss derived by a participant in a global dealing operation, as defined in §1.482–8(a)(2)(i), shall be sourced under the rules set forth in §1.863–3(h).

* * * * *

Michael P. Dolan,
Deputy Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on March 2, 1998, at 1:50 p.m., and published in the issue of the Federal Register for March 6, 1998, 63 F.R. 11177)

Foundations Status of Certain Organizations

Announcement 98–29

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

Ahepa Ypsilanti Chapter No. 118
Foundation, Toledo, OH

American Friends of the Institute of

Talmudic Studies, Inc., Lakewood, NJ
Apex Capital, Inc., Cleveland, OH
Baton Rouge Rehab Community Homes,
Bossier City, LA
Boston Foundation, Leavenworth, KS
Bright Light Corp., Atlanta, GA
California Compact Inc., Phoenix, AZ
Childrens Educational Project, Inc., New
York, NY

Childrens Trust Fund of Northeast

Florida, Inc., Pensacola, FL
Childrens Wildlife Preserve, Tucson, AZ
Chips of New Jersey Inc., Caldwell, NJ
Christian Foreign Missions Inc., Phoenix,
AZ

Christian Haitian American Community
Services, Inc., Miami, FL

Christian Health Institute and Wellness
Center, Inc., Bloomfield, NJ

Christian Lighthouse Network Inc.,
Tallahassee, FL

Coleman Community Foundation,
Coleman, OK

College Attain Inc., Royal Palm Beach,
FL

College Hispanic Council Inc., Miami,
FL

Community Language Institute, San
Rafael, CA

Comstock Foundation, Phoenix, AZ
Concerned Americans for Cultural

Change, Southfield, MI

Concerned Citizens Against Drugs,
Painesville, OH

Conference of Community Health
Centers, Inc., Cincinnati, OH

Congregations Allied for Community
Improvement, Saint Louis, MO

Council for Marriage Preservation &
Divorce Resolution, Inc., Fort
Lauderdale, FL

Counseling and Enrichment Center Inc.,
Columbus, GA

Coventry People Enhancing a Child's
Environment, Incorporated, Cleveland
Hts, OH

Creating Opportunities for Parent
Empowerment Coalition, Washington,
DC

Creative Directions of Acadiana Inc.,
Scott, LA

Creative Learning and Child Care,
Severn, MD

Crescendo, The Tampa Bay Womyns
Chorus, Inc., Tampa, FL

Criminal Justice Policy Foundation,
Boston, MA

Crisis Pregnancy Center of Jefferson
 County, Mount Vernon, IL
 Cultural Crossovers, Inc., New York, NY
 Deedco Gardens Inc., Miami, FL
 Dream Maker Charitable Trust, Bethany,
 OK
 Emerald Isle Immigration Center Inc.,
 Pompano Beach, FL
 Emergency Assistance Program, West
 Branch, MI
 Emet Services Incorporated,
 Philadelphia, PA
 Englewood Hispanic Association Inc.,
 Englewood, NJ
 Englewood Social Services, Chicago, IL
 Enterprise Developmental, Bethesda, MD
 Environmental Communications,
 Phoenix, AZ
 Everlasting Tape Ministry and Caption
 Service, Vancouver, WA
 Florida Section American Water
 Resources Association Inc., Boynton
 Beach, FL
 Floyd County Token Club Inc., New
 Albany, IN
 Floyd County Youth Services Coalition
 Inc., New Albany, IN
 Flyt Gymnastics Team Association,
 Chicago, IL
 Focus Inc., Columbia, TN
 Focus Children Center LTD,
 Albuquerque, NM
 Fort Worth Educational Council Inc., Fort
 Worth, TX
 Foundation for Tropical Research and
 Exploration, Chicago, IL
 Foundation Lighthouse Inc., Lincoln, NE
 Foundation of America, Salt Lake City,
 UT
 Foundation on Aging, Merriam, KS
 Foundation To Save Our Childrens
 Environment, Tulsa, OK
 The Francesa Ronnie Primus Foundation
 Inc., W. Hempstead, NY
 Good News Foundation of Central NY,
 Inc., Utica, NY
 Greater Houston Sports Association Inc.,
 Houston, TX
 Greater Indianapolis Track Club Inc.,
 Indianapolis, IN
 Greater Kansas City Football Coaches
 Association, Blue Springs, MO
 Greater Louisville Council on Sexual
 Health and Addiction Inc., Louisville,
 KY
 Greater Melbourne Soccer Association
 Inc., Palm Bay, FL
 Greater Piedmont Foundation Inc.,
 Greensboro, NC
 Greater St. Louis Construction Workforce
 Coalition, St. Louis, MO
 Greene County Fair Housing Advisory
 Board, Xenia, OH
 Greene County Landmarks Foundation
 Inc., Bloomfield, IN
 Greensboro Homeless Workers Inc.,
 Snow Camp, NC
 Greenville Theatre Arts Center Inc.,
 Greenville, NC
 Greenwood Foundation Inc., Tulsa, OK
 Hatpeth Terrace Health Center, Franklin,
 TN
 Health and Education Services, Inc.,
 Beverly, MA
 Home of Hope Inc., Jacksonville, FL
 Homebound Elderly Rehabilitative
 Opportunities Foundation, Dover, DE
 Homeless Assistance Organization,
 Inkster, MI
 Horizon Community Residence,
 Houston, TX
 Horry County Air Rescue Inc., Myrtle
 Beach, SC
 Horses for the Handicapped Inc.,
 Hollywood, FL
 Hospice Care of Carroll County Inc.,
 Carrollton, GA
 Hospice Foundation of Cross Timbers
 Inc., Abilene, TX
 Hospice of Cheat River Inc., Saint
 George, WV
 Hospice of Mercy Foundation, Mexia, TX
 Innovative Human Services Corporation,
 Southfield, MI
 Institute for Educational Research for
 African American Male Study, New
 Orleans, LA
 Italian Village and Cultural Center
 Incorporated, Torrance, CA
 Jewish Outreach Center Inc., Richardson,
 TX
 Jim Burkeholder Family Learning Center
 Inc., Lubbock, TX
 Kendall County Community Health
 Center Inc., Boerne, TX
 Kenosis Inc., New Orleans, LA
 Kensington Court Inc., Norfolk, VA
 Kincaid Community Composting, Inc.,
 Marietta, GA
 The Kings College Foundation, Inc.,
 Albany, NY
 Last Chance for Life Inc., Oklahoma
 City, OK
 Latch Key Center of Memphis, Memphis,
 TN
 Lathrup Village Historical Society Inc.,
 Lathrup Village, MI
 Latin American Association of North
 Carolina-LAANC, Raleigh, NC
 Latin-American Ethnic Foundation,
 Shawnee, KS
 Latino Civil Rights Task Force,
 Washington, DC
 Lewis Group Home Inc., Canton, OH
 Liberian After War Relief Fund Inc.,
 Alexandria, VA
 Liberty Air Museum Inc., Elyria, OH
 Liberty Place Inc., Garden City, KS
 Libros Para Ninos, St. Paul, MN
 Licking Arc Apartments Inc., Newark,
 OH
 Life Athletes Inc., Chatham, NJ
 Living Water Evangelistic Association,
 Irmo, SC
 Livingston Council for Accessible
 Housing Inc., West Orange, NJ
 Longmont High School Education
 Foundation Inc., Longmont, CO
 Longwood Babe Ruth Baseball League of
 Seminole County Inc., Longwood, FL
 Loramie Watershed Association Inc., Fort
 Loramie, OH
 Lord Berkeley Conservation Trust,
 Moncks Corner, SC
 Lords Table of Indian River County Inc.,
 Sebastian, FL
 Melville House, Inc., Roslyn, NY
 Metropolitan Entertainment, Sterling
 Heights, MI
 Montezuma County Hospital District
 Foundation, Inc., Cortez, CO
 Montgomery County Animal Alliance
 Inc., Kensington, MD
 Montgomery County School Safety
 Committee, Inc., Rockville, MD
 National Smokejumpers Association,
 Missoula, MT
 National Soccer Foundation,
 Miamisburg, OH
 National South Asian AIDS Organization,
 River Forest, IL
 Native American Alliance of Ohio,
 Thornville, OH
 Native American Expressions Inc., Fort
 Pierre, SD
 Navajo School Alumni Association,
 Altus, OK
 Naval Home Memorial Windows
 Committee, Inc., Gulfport, MS
 Nawake Conference & Retreat Center,
 Inc., Newport, AR
 Nebraska Environment Education,
 Wahoo, NE

Nebraska Health-Fitness Coalition for Youth, Lincoln, NE	Ragged Mountain Wolf Rescue Fund Inc., Marble, CO	Rotary Foundation of South Miami, Inc., Miami, FL
Nebraska Homeless Veterans Shelters Programs, Inc., Lincoln, NE	Rainbow Falls Corporation, Wichita Falls, TX	Routt County Sheriffs Reserve Inc., Steamboat Springs, CO
Nebraska Law Enforcement Intelligence Network, Plattsmouth, NE	Rainbow Promise Ministries, Denver, CO	Royal Mohammed Ali Pasha Foundation, Washington, DC
Neighborhood Rehabilitation Center, Inc., Arlington, TX	Rampart Range Motorcycle Management Committee, Inc., Englewood, CO	RPFD & ND Inc., Jackson, MS
New York Retinal Research Foundation, Inc., New York, NY	Randolph Advocates for the Developmentally Disabled, Asheboro, NC	Ruby Life Memorial Scholarship Corporation, Corinth, MS
Northeastern Lumber Manufacturers Institute, Cumberland Center, ME	Rangers Youth Athletic Organization Inc. In Texas, El Paso, TX	Rubys Daycare Center Inc., Jackson, MS
Oak Lawn Community House Inc., Dallas, TX	Raton Rodeo Association, Raton, NM	Running Creek Counseling Service, Franktown, CO
Oakland County Express, Farmington Hills, MI	R Center Inc., Houston, TX	Rural Affordable Housing Inc., Tempe, AZ
Ocean Kids, Inc., New York, NY	Regional Environmental Monitoring Association, Inc., Beaver Falls, PA	Rural Enterprise Adaptation Program, Cedar Rapids, IA
Ocala Youth Baseball Association Inc., Ocala, FL	Relationship Enhancement Foundation, Tucson, AZ	Rural Opportunities Corporation, Carrboro, NC
Operation Shelter Inc., Grosse Pointe Park, MI	Remember My Name Committee, Lansing, MI	Sada-Sewa Foundation Inc., Baldwin, NY
Orange-Calhoun-Allendale-Bamberg Community Development Corporation, Bamberg, SC	Renaissance Club Inc., Arlington, VA	Save the C S S Alabama Committee, Mobile, AL
P.A.B. Alumni, Chicago, IL	Renewable Resources Fellowship LTD, Peoria, IL	Save West Virginia Jobs, Inc., Fairmont, WV
Pam Foundation Inc., Tampa, FL	Rennebaum Foundation for the Arts, Middlesboro, KY	S E E D Ministries Inc., Somerville, TX
P.C. Development Corporation, Port Clinton, OH	Research Center for Experimental Theatre—RECET, Philadelphia, PA	S E L F Inc., Peoria, IL
The Penobscot Center for Marine Studies Inc., West Buxton, ME	Research Fund Inc., Laytonsville, MD	Ship 364, Inc., Virginia Beach, VA
Pineywoods Art League of East Texas, Jasper, TX	Resident Advisory Board of Southward Village Annex, Inc., Ft. Myers, FL	Southern Indiana Family Education, Inc., Columbus, IN
Polish American Club, Columbus, OH	Resident Council of Pecan Grove, Paragould, AR	Supernal Initiatives Inc., Lexington, KY
Ponca Hills Preservation Association Inc., Omaha, NE	Residing in Group Housing Together—RIGHT, Washington, DC	The Terezin Foundation, Inc., New York, NY
Porcine Interest Group Inc., Columbus, OH	Resource for Christian Leadership, Inc., Charleston, SC	Triway Athletic Booster Club, Wooster, OH
Port Aransas Council for the Arts Inc., Port Aransas, TX	Restaurants United To Serve the Homeless, Inc., Ponte Vedra Beach, FL	
Producciones Flor De Cahillo Inc., Rio Piedras, PR	Restoration Ministries Inc., Philadelphia, PA	
Professional Female Politicians, Greensboro, NC	Restorers-Teachers and Friends, Chicago, IL	
Professional Sports Linkage Inc., Minneapolis, MN	Return to Life House Inc., Red Bank, NJ	
Rabun County Interagency Coalition, Dillard, GA	Robert Chesley Foundation, Inc., Los Angeles, CA	
Racquetball 96 Inc., Atlanta, GA	Rotary Club of Big Rapids Foundation, Big Rapids, MI	

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it ap-

plies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.

E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.

PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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¹ A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 1997–27 through 1997–52 will be found in Internal Revenue Bulletin 1998–1, dated January 5, 1998.

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